HISTORY & PROBLEMS OF INDIAN CURRENCY

1835 - 1939

AN INTRODUCTORY STUDY

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PREFACE

I have attempted in these pages to give a clear and concise account of the main developments in our currency system during the last one hundred years. Public interest in monetary questions has increased in recent years and the ratio-controversy has focussed attention on one of the most vital problems of Indian currency. I hope a perusal of these pages will enable the reader to understand the mechanism of the Indian currency system and the objective of Indian currency policy and follow with keener interest future currency developments. The stream of Indian currency broadens out after the publication of the Hilton Young Commission's report in 1926 and proportionately larger space has been given to an examination of issues and developments subsequent to that date. The subject has been brought up to-date, though there can naturally be no finality of argument or opinion about recent developments. I have preferred not to relegate paper currency to a separate chapter but to treat it as an integral part of the currency system. This booklet grew out of lectures to B. A. Pass and Honours students and was designed primarily for them. I believe, however, that it is not too abstruse for the general reader.

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INTRODUCTION

A general acquaintance with the mechanism of foreign exchange is necessary to understand properly the history and problems of Indian currency. The history of Indian currency is very largely a history of its fortunes vis-a-vis the British currency. It may not, therefore, be out of place to give in the beginning of this tract a general idea of the causes underlying fluctuations of exchange between countries with different monetary systems.

The need of exchanging one currency into another arises on account of differences in the currencies of the countries all over the world. The currency of one country is useless *as currency* when taken out to another country. England has its pound, France its franc, Russia its rouble, Japan its yen, America its dollar and India its rupee. When payments have to be made to the people of another country, one currency must be exchanged into another. This raises the important question: how much of one currency will be given to get a certain quantity of the other. In other words, how will the rate of exchange be determined?

Broadly, four cases may be considered to know how the rate of exchange is determined and how far its variations can go. These four cases are of :

(*i*) Two countries both on metallic standard—gold standard or silver standard.

(*ii*) Two countries, one on gold standard and the other on silver standard.

(*iii*) Two countries, one on metallic (gold or silver) standard and the other having paper currency not convertible into gold or silver.

(*iv*) Two countries, both having inconvertible paper currency.

I Case : Two countries on metallic standard

A country is said to be on gold (or silver) standard when its unit of account is a gold (or silver) coin freely minted by the government, its paper currency is freely convertible into gold (or silver) coins and free export and import of gold (or silver) are allowed. The unit of account may also be a certain fixed quantity of gold (or silver) in uncoined form. In that case, too, the country is said to be on gold (or silver) standard, though more strictly it should be said to be on gold (or silver) *bullion* standard.

Between two countries both having gold coins as units of account, the rate of exchange will *tend to* equal the ratio between the amounts of gold contained in the coins. This ratio is called the *mint par of exchange*. Before the Great War, for instance, both England and France were on gold standard, the mint par of exchange being 25 francs to the pound. The rate of exchange that *actually comes to prevail* is seldom equal to the mint

par. It varies in response to changes in trade and a few other causes but limits to its variations are set by the cost of transporting gold from one country to the other. This needs a bit of explanation. Imports into a country from another country must ultimately be paid for in the currency of the exporting country. Imports from France into England must be paid for by British importers in francs. Similarly imports into France from England will have to be paid for in British currency. Imports create a demand for the currency of the country from where they come and exports create a command over the supply of the currency of the country to which they are sent. The price that people in a country will pay in terms of their own currency for the currency of another country will be determined by the demand for and the supply of foreign currency. In other words, the rate of exchange at any time will depend upon the relative amount of exports and imports. If exports increase, the supply of foreign currency at the disposal of the country is extended and its price in terms of the currency of the country will tend to fall i.e., a smaller amount of home currency will tend to purchase a given amount of it. If, on the other hand, imports increase, the demand for foreign currency is extended and more in home currency will have to be given to purchase a given quantity of it i.e., the same amount of home currency will tend to purchase less of foreign currency.

Mint par : one £ : 25 Francs.

If exports from England increase, one £ *tends to* exchange for 26 francs.

If imports into England increase, one £ *tends to* exchange for 24 francs.

These fluctuations in the rate of exchange due to balance of trade and other causes cannot, however, go beyond certain points. Exchange of one gold coin into another gold coin will stop as soon as it becomes less profitable than a direct shipment of gold from or to the other country. If the cost of sending out gold contained in the coin is less than the cost of exchanging the coin for a foreign gold coin, export of gold will be preferred to exchange of currency. The rate of exchange cannot rise above or fall below certain points. As soon as these points are reached, people find export or import of gold cheaper than purchase or sale of foreign currency. These points are called *gold points* and are found by adding to and deducting from the mint par the cost of transport of gold.

It only remains to add that foreign currency is bought and sold through banks and the medium used is that of bills of exchange which are simply orders to pay specified amounts of the currency of a country.

An Example:—

Upper gold point

Mint par : one £=25 francs

If exports from England increase, 1 £ will tend to exchange for 26 francs.

Cost of transport of gold contained in a £ is, let us say, 1/4 franc.

A British exporter will find it cheaper to get gold contained in 26 francs direct from France. He will receive minus cost of transport 25¾ francs which are equivalent to more than a £ (mint par : £=25 francs). No exporter will, therefore, receive less than one pound for every 25¼ francs from a bank. This is the upper gold point. The rate of exchange cannot rise higher than this, for an import of gold into England will be induced.

Lower gold point

Mint par: one £=25 francs

If imports into England increase, 1 £ will tend to exchange for 24 francs.

Cost of transport of gold in a £=¼ franc.

A British importer will find it cheaper to export gold contained in a pound than to get 24 francs through the bank. By exporting gold directly he can remit after paying cost of transport, 24¾ francs. The rate of exchange will not, therefore, fall below this point. This is the lower gold point. A fall below this point will

lead to export of gold.

The rate of exchange will therefore fluctuate between $24\frac{5}{8}$ and $25\frac{1}{4}$ francs to the £.

Fluctuations of exchange and limits to them between two countries on silver standard are determined in the same way.

II Case : Two countries—one on gold standard and the other on silver standard.

In this case there is no mint par as such. The ratio between the metallic contents of the two currencies is variable, depending on the price of silver in terms of gold. The rate of exchange, therefore, depends upon three factors : (*i*) the volume of exports and imports, (*ii*) gold price of silver and (*iii*) cost of transport of gold or silver from one country to the other. The value ratio between silver and gold from the middle of the seventeenth century and throughout the eighteenth varied between $13\frac{5}{8} : 1$ and $15\frac{1}{4} : 1$ but after 1870 this ratio was disturbed.[1]

From 1835 to 1893 India was on silver standard and England on gold standard. In 1871-72 when the price of silver was $60\frac{1}{2}$ d. per ounce, the Indian rupee was equivalent to a little less than 2s. After 1873, the price of silver in terms of gold fell. Naturally the price of silver in the rupee in terms of gold in the pound also fell. In 1893, when the gold price of silver was 39d. per ounce, the Indian rupee became equivalent to only

[1] Knut Wicksell: Lectures on Political Economy, Vol. II, P. 36.

1s. 3d. During the same period fluctuations of exchange took place in response to changes in balance of trade also—within the limits set by cost of transport.

III Case and IV Case : Two countries—one of which or both of which are on inconvertible paper standard.

These two cases may be considered together because they bear the same explanation. In these cases, there is no mint par as such and the question of cost of transport of metal from one country to the other does not arise because in one or both of the countries the currency is not convertible into bullion or coin.

Here the rate of exchange between the countries tends to equal the ratio between the purchasing power of the currencies of the two countries. If, for instance, one paper pound has the same purchasing power against commodities as five paper dollars, rate of exchange will oscillate about the parity : 1£ : $ 5. Purchasing power of a currency is indicated approximately by the index numbers of prices. Exchange fluctuations will no doubt take place in response to changes in trade and other causes but will *centre round this purchasing power parity.*

During the last Great War many countries went off metallic standards and inflated their paper currencies. The old way of explaining fluctuations in the rate of exchange became utterly inadequate. A new explanation was necessary and this was provided by Prof. Gustav Cassel, the Swedish economist. He propounded the now famous theory of Purchasing Power Parity. The

theory may be explained in his own words:

"Our willingness to pay a certain price for foreign money must ultimately and essentially be due to the fact that this money possesses a purchasing power against commodities and services in that foreign country. On the other hand, when we offer so and so much of our money, we are actually offering a purchasing power as against commodities and services in our own country. Our valuation of a foreign currency in terms of our own, therefore, mainly depends on the relative purchasing power of the two currencies in their respective countries .... When two currencies have undergone inflation, the normal rate of exchange will be equal to the old rate multiplied by the quotient of the degree of inflation in the one country and in the other. There will naturally always be found deviations from this new normal rate and during the transition period these deviations may be expected to be fairly wide. But the rate that has been calculated by the above method must be regarded as the new parity between the currencies, the point of balance towards which, in spite of all temporary fluctuations, the exchange will always tend. This parity I call *purchasing power parity*"[1].

Into the refinements and criticisms of this theory it is needless to enter. The theory has been accepted in essentials and used to explain the normal rates of exchange and exchange fluctuations not only of inconverti-

[1] Cassel: Money and Foreign Exchange after 1914: p. 138-40.

ble paper currencies but of currencies based on a metallic standard as well. The parity of purchasing power is a wide parity and includes mint par of exchange.

An Example:—

1913 : England		France
Mint par: £	=	25 Francs

Index Nos. of prices

	England	France
1913	100	100
1920	300	500

Purchasing power parity : £=25 × $\frac{500}{300}$ francs.

or £=41.7 francs.

The figures taken here are true to facts to a small extent and the parity thus worked out also accords to some extent with the actual rate in January 1920 but it may be noted that this method of working out purchasing power parity is rather crude.

CHAPTER I

A BRIEF OUTLINE

The history of Indian currency can be divided into more or less defined periods. It may be taken to date from 1835—the year in which the rupee was established as the standard coin throughout the territories of the East India Company. The following periods may be marked :—

I Period : 1835—1893, during which India was on silver standard. This period may further be split up into two periods : (a) 1835—1874, during which efforts made to secure gold currency for the country proved abortive and (b) 1874-1893, during which the gold price of silver fell and led eventually to the suspension of silver standard.

II Period : 1893—1898 : A period of transition which was to precede introduction of gold standard with gold currency.

III Period : 1899—August, 1917 : A period during which the Government set out to establish gold standard but drifted on to gold exchange standard.

IV Period : August, 1917—1920 : A period of unstable exchange during which the Government took measures to regulate currency.

V Period : February 1920—September 1920 : A

short period during which the Government tried unsuccessfully to restore stable gold exchange standard by holding the exchange at 2s.(gold) and involved Indian exchequer in a huge loss.

VI Period : 1920—27 : A period during which the Government gave up attempts to *maintain* a particular exchange rate, but not those to *secure* a particular exchange rate.

VII Period : 1927—September, 1931 : A period during which gold exchange standard (actually sterling exchange standard) was restored and efforts continuously made to maintain the rate at 1s. 6d.

VIII Period : September 1931—1939 : A period of crisis and uncertainty which began with rupee being linked to sterling and during which the Indian currency system has been weathering the economic storm.

It would be helpful to know that running like two threads through the history of Indian currency are the desire of Indian people to have a gold standard and the anxiety of the Government to maintain a stable exchange rate at all costs.

CHAPTER II

I Period: 1835—1893

FROM ADOPTION TO ABANDONMENT OF SILVER STANDARD

Attempts by the East India Company to reform Indian currency had begun much before 1835 and the silver rupee weighing 180 grains (11/12th fine) was made the standard coin in Madras in 1818 and in Bombay in 1823.[1] In 1835 (by the Act No. XVII) the silver rupee of 180 grains (11/12th fine) was made the standard coin throughout British India.[2] Mints were opened to the free coinage of silver. The face value of the rupee was equal to its intrinsic value i.e., the value of the rupee against gold or commodities was equal to the value of silver contained in the rupee. It must be obvious that coinage being free to public it was not possible for the Government to make the rupee circulate at a value higher than that of silver put in the rupee.

[1] Reform was needed because of the large variety of coins of gold and silver circulating in different parts of the country. 994 coins of varying weight and fineness are said to have been circulating about this time.

[2] The weight and fineness of the rupee remain unaltered upto this day.

§ 1. Attempts to Introduce Gold in Circulation (1835—1874)

By the Act of 1835, which made the silver rupee standard coin, gold coins were deprived of their legal tender quality i.e., legally they could not be paid and accepted. The Act permitted, however, the coinage of gold mohars if required by the public. These mohars were to be equal in value to 5, 10, 15, or 30 rupees. It is difficult to understand why the gold coins struck under the Act were not to be legal tender. A proclamation issued in 1841 authorised receipt of gold coins at public treasuries in payment of public dues at their face value unless they had passed a certain limit of lightness when they were to be taken as bullion only, by weight. The rate at which gold coins were to be received was 15 : 1. Some encouragement was thus given to gold currency but it was to be very brief. Gold discoveries in California and Australia from 1848 to 1851 made it cheaper for the people to pay in gold rather than silver at the rate of 15 : 1. Gold began to flow to the treasuries in large quantities and the Government lost by accepting it at a rate higher than the market rate. From 1st January, 1853, therefore, receiving of gold coins in payments of public dues was stopped. Gold, however, continued to be received into the mint for coinage under the Act of 1835.

Mansfield Commission, 1866

Proposals were made after 1853 to introduce gold

currency in India. Several Chambers of Commerce and Sir Charles Trevelyan (in his Minute of 20th June, 1864) pressed for the introduction of gold coins in India and the Government of India agreed to receive and pay, when convenient, sovereigns and half-sovereigns minted at any authorised mint in England or Australia at the rate of Rs. 10 and Rs. 5 respectively. The gold coins were not to be legal tender, however. At these rates gold coins were not tendered at the treasuries. A Commission was appointed in 1866 under the chairmanship of Sir William Mansfield to report on the best way of meeting the currency demands of the country. The Commission made the following recommendations :—

(*i*) gold coins of 15, 10 and 5 rupees should be issued.

(*ii*) currency should consist of gold, silver and paper.[1]

(*iii*) the possibility of issuing a universal note should be considered.[2]

Nothing resulted from these recommendations. In 1868, the rate for sovereigns and half-sovereigns was raised to Rs. 10-4 and Rs. 5-2 respectively to attract gold

[1] Currency notes had been issued and made full legal tender within their respective circle of issue by the Paper Currency Act of 1861. The Commission were to report on the working of this Act also.

[2] To anticipate things a little, it may be mentioned here that five rupee note was made universal legal tender in 1909, ten and fifty rupee notes in 1910 and hundred rupee note in 1911. Five hundred and one thousand rupee notes were made universal legal tender in 1931.

to the treasuries. Shortly after this gold price of silver began to fall and in May 1875, the Governor-General in Council expressed his unwillingness to take any step to recognize gold as the standard of value in India.

§ 2. Fall in the gold price of silver (1874—1893)

From 1874 onwards the gold price of silver began to fall. From $60\frac{1}{2}$d per ounce in 1871-72 it fell to 39d. in 1892-93. From 1873 to 1893, the fall amounted to 40%. As the silver rupee was a freely minted coin, the value of silver in the rupee in terms of gold also began to fall and the rate of exchange fell from 1s. $11\frac{1}{8}$d. to 1s. 3d. in 1892-93. There were two kinds of causes accounting for the fall in the gold price of silver :—

(*a*) Depreciation (fall in value) of silver due to increased production of silver and demonetization of silver by several countries such as Germany, Sweden, Denmark, Norway, etc.

(*b*) Appreciation (rise in value) of gold owing to its decreased production and increased demand from countries adopting gold standard such as Germany and Scandinavian countries.

For a long time the Government took no action and waited for the introduction of international bimetallism. The last of the International Monetary Conferences held at Brussels in 1892 adjourned without arriving at any agreement. The difficulties of the Government and people had in the meantime become acute owing to the

following reasons :—

(*i*) To meet their Home Charges (i.e., expenditure in England) they had to remit a larger number of rupees and this necessitated increased taxation.

(*ii*) Fluctuations of exchange introduced uncertainty so harmful to trade. It is sometimes said that a falling exchange stimulates exports but there was evidence to show that the progress of export trade was less with a rapidly falling than with a steady exchange.[1]

(*iii*) The European officials who made remittances abroad claimed compensation for the loss they suffered due to a fall in exchange. The prices in England had no doubt fallen at that time but even allowing for that the amount of sterling which the same number of rupees procured had been largely reduced.

(*iv*) A falling exchange greatly checked the investment of British capital in India because there was uncertainty as to the interest received from such investment and the reduction that the principal sum may suffer when it was retransferred to England at a lower rate.

(*v*) A falling exchange involving as it did smaller remittances for the same number of rupees, made it more difficult to arrange for the services of European employees to carry on industrial undertakings in India.

The Herschell Committee, 1892

In 1892, a committee was appointed under the

[1] Report of Herschell Committee (1893), para 27.

chairmanship of Lord Herschell to consider if it was expedient to close the mints to the free coinage of silver with a view to the introduction of gold standard, as was suggested by the Government of India. The object of closing the mints to the free coinage of silver was to secure control over the supply of rupees and prevent a fall in the exchange value of the rupee. The Herschell Committee recommended that :—

(*i*) Mints should be closed to the free coinage of both silver and gold,[1] but the Government should retain the liberty to coin rupees if required by the public in exchange for gold received in Government treasuries at the rate of 1s. 4d. : Re.

(*ii*) The rupee must remain full legal tender.

By Act No. VIII 1893, mints were closed to the free coinage of silver though the Government retained the power to coin rupees on their own account. Three notifications (Nos. 2662-64) were also issued making arrangements for (a) the receipt of gold at the mints at the rate of 7.53344 grains of fine gold per rupee or 16d. : Re.[2] (b) receipt of sovereigns and half-sovereigns in payments of public dues at 16d. : Re and (c) issue of currency notes to the Controller General in exchange for British gold or gold bullion.[3] The aim of the Act

[1] This deserves notice because the Act of 1835 and later the Indian Coinage Act of 1870 permitted coinage of gold for the public though gold was not legal tender. The Act of 1893 stopped even coinage of gold.

[2] This notification was withdrawn in 1906.

[3] This notification was supplemented by the Paper Currency

and the notifications was to raise the gold value of the rupee to 1s. 4d. by restricting its supply, make it effective at that rate and then to introduce gold standard.

Act of 1910 which provided for issue of notes against British gold coin.

CHAPTER III

II Period: 1893-1898

A PERIOD OF TRANSITION

In a telegram of the 22nd January, 1893, the Government of India had said, "We think that an interval of time, the length of which cannot be determined beforehand, should elapse between closure of the mints and any attempt to coin gold here." During this interval which extended from 1893 to 1898, the exchange value of the rupee fell in the beginning so low as 1s. 1d. in 1894[1] but recovered later and was 15.9d. in 1898. The Government of India now made proposals to end the period of transition and to take "active steps to secure the early establishment of a gold standard and a stable exchange." These proposals were (*i*) to raise the rate to 16d. (it was then a little less) by withdrawing some rupees from circulation and melting them (*ii*) to raise a loan in England and to remit part of it to India in sovereigns to serve as gold reserve against note-issue, (*iii*) to sell silver bullion obtained from melted rupees and add gold to the reserve and (*iv*) to part with gold only

[1] This was due to suspension of silver purchases by America and an apprehension about a fall in the value of silver rupees which were, therefore, brought out of hoards to be disposed of before further fall occurred.

after the rate had been established at 16d.

The Fowler Committee, 1898

In 1898, a committee was appointed presided over by Sir Henry Fowler to consider these proposals for making effective the policy initiated in 1893. The committee had also to suggest ways of securing a satisfactory system of currency and stable exchange.

The Committee was against reverting to silver standard and made the following important recommendations :—

(*i*) The British sovereign should be made a legal tender and a current coin in India. Indian mints should be thrown open to the unrestricted coinage of gold on such terms and conditions as govern the three Australian branches of the Royal Mint.

(*ii*) The rate of exchange should be made stable at 1s. 4d. : Re.

(*iii*) Rupees should remain unlimited legal tender.

(*iv*) The Government should continue to give rupees for gold but fresh rupees should not be coined until the proportion of gold in the currency is found to exceed the requirements of the public.

(*v*) Any profits on the coinage of rupees should be accumulated in a special reserve fund.

(*vi*) No legal obligation should be imposed on the Government to give gold for rupees ; for this would make the Government liable to find gold at a moment's notice in undefined amounts.

(*vii*) The Government should make gold available for export if exchange shows a tendency to fall below the specie point.

In two respects the currency system recommended by the Committee differed from the ordinary gold standard. In the first place, though gold coins were to be freely minted and were to be full legal tender, there was to be no *legal* obligation on the Government to convert rupees into gold. Secondly, the rupees, quite unlike subsidiary coins under gold standard were to remain full legal tender.[1] The Committee, it is clear, looked forward to the ultimate establishment of gold standard with gold currency and had meanwhile recommended for adoption a close approximation of it.

[1] Cf. however, "It is sometimes erroneously believed. ....that the proper position of a rupee under a gold standard is not to be unlimited legal tender." Dr. Jain, The Monetary Problems of India, p. 29.

CHAPTER IV

III Period: 1899—*August* 1917

EVOLUTION, MECHANISM AND BREAKDOWN OF GOLD EXCHANGE STANDARD

§ 1. Evolution of Gold Exchange Standard

The effective establishment of gold standard was the paramount object which the Fowler Committee set before the Indian authorities. The Government of India decided to take action on the recommendations of the Committee. The Indian Act No. XXII of 1899 made the sovereign and half-sovereign legal tender throughout India at Rs. 15 : £ (1s. 4d. : Re.). Active steps were taken to open a mint for the coinage of gold in India but the scheme was dropped after nearing completion in 1902. A reserve, called the Gold Reserve, was created to set apart the profits on the coinage of rupees. An active effort was made to induce the people to use sovereigns as a medium of exchange and Currency Offices, Post Offices and Government institutions were instructed to pay out sovereigns to the public. The results were unsatisfactory and a large number of gold coins were returned to the Government treasuries. In many places sovereigns went to a discount of as much as 4 annas. At the same time there was such a large demand for

rupees that the Government were compelled to resume the coinage of rupees early in 1900. The profits on the coinage were credited to the Gold Reserve. After 1900 the experiment of putting gold coins into circulation was not repeated. Apparently it was concluded by the Government that people did not want gold coins. The conclusion was wrong because both the time and manner of putting gold coins into circulation were ill-chosen. Famine conditions prevailed about this time and rupees were needed for small payments. The method of forcing sovereigns simultaneously from several sides on the people was hardly correct. With the odds against them the Government tried to take the citadel by storm and when the first attack was repulsed threw up their hands in despair.

After this, the currency system steadily deviated away from the aim of an effective gold standard. In 1900 the experiment of making people use gold coins failed. In 1902, the scheme of gold mint was dropped owing to the disapproval of British treasury authorities.[1] In the same year the arrangement initiated in 1899 of issuing currency notes against gold received by the Se-

[1] One of the reasons for disapproval was that "sovereigns were being rapidly attracted to India whenever required and there was no reason for believing that the position of gold standard in India would be strengthened or public confidence in the intentions of the Government of India confirmed, by the mere provision of machinery for the manufacture of gold coins in the country."

(*Government of India despatch quoted in the minute of dissent to the Hilton Young Commission's report, p.* 105).

cretary of State in London was made permanent.[1] In 1904 the Secretary of State notified his willingness to give rupees for sterling without limit at a rate based on 1s. 4d. : Re. The reserve constituted out of the profits on the coinage of rupees—the Gold Reserve—was remitted, according to the Secretary of State's decision, to London in gold and invested in sterling securities. The original object of this reserve was to ensure convertibility of Indian currency into gold at 1s. 4d. : Re. and thereby make gold standard effective. The Secretary of State, however, held that as a large demand for conversion of rupees into gold would arise only in an emergency when balance of trade turned against India and large payments had to be made in London, the Reserve should be kept in London. The Fowler Committee never intended that the reserve should be so kept nor could they ever dream that the Reserve would be drawn upon, as it was actually drawn upon in 1907 to the extent of £ 1,123,000, for expenditure on railway development. In 1907 a rupee branch of the Gold Reserve was created to ensure ready supply of rupees in exchange for gold tendered in India at 1s. 4d. : Re. and to prevent thereby a rise in the exchange rate. The name of the Reserve after the creation of this branch was changed into Gold

[1] The gold received by the Secretary of State was kept as a part of the reserve to back Indian Paper Currency. This reserve—known as the Paper Currency Reserve—was meant to ensure convertibility of currency notes into rupees and gold coins and was held hitherto in securities, silver and gold. Now a part of it came to be held in gold in London.

Standard Reserve which now consisted of a rupee portion and sterling securities portion. In 1908 when the balance of trade turned against India, exchange tended to fall and there was a strong demand for gold for export, the Government after much hesitation made available gold out of the London branch of Gold Standard Reserve against rupees received by them in India. More than £ 8 millions were withdrawn out of the London branch of Gold Standard Reserve.

All these various steps taken by the Government of India were nowhere recommended by the Fowler Committee. It appears that after having got loose of the sheet anchor of gold standard, the Government policy steadily drifted quite unconscious of the destination to be reached. The various steps the Government took during this period were in the nature of experiments to maintain the value of the rupee at 1s. 4d. These steps led, however, to the adoption by India of a new kind of currency system known as Gold Exchange Standard. This system had no basis in law ; for it was the result of a series of administrative acts. It was not adopted as a consistent whole ; for it was never consciously designed.

As this system functioned upto 1917 in spite of the stress and strain of early war years, its mechanism may be clearly explained.

§ 2. Mechanism of Gold Exchange Standard

The germs of a system resembling Gold Exchange Standard are to be found in the writings of Ricardo,

the famous British economist, who believed that a currency is in its most perfect state when it consists of a cheap material which has an equal value with the gold it represents. The gold is available for purposes of export only and does not enter into the internal circulation of the country. A system resembling the one advocated by Ricardo was introduced in several countries in an imperfect form but India was the first country to adopt it in a complete form[1].

The essentials of Gold Exchange Standard system are three :-

(*i*) A cheap currency consisting of tokens. In India it consisted of silver rupees and currency notes.

(*ii*) The currency is not convertible into gold for internal use but the Government or the Central Bank of the country makes gold (or the currency of a country on gold standard) available to the people for purposes of foreign payments at a fixed rate in return for cheap internal currency. In India, the Government made arrangements for converting internal currency into British currency based on gold.

(*iii*) Funds or reserves are kept in a foreign country to make gold (or currency of a gold standard country) available to the people for foreign payments. In the case of India the Gold Standard Reserve was constituted.

One great merit of such a system is that the country avoids the use of a costly gold currency but has gold at

[1] J. M. Keynes: Indian Currency and Finance, p. 33.

its command to make foreign payments.

The Gold Exchange Standard in the form in which it was adopted in India is known as the Lindsay Scheme. Mr. A. M. Lindsay, the Deputy Secretary of the Bank of Bengal,[1] in his evidence before the Fowler Committee proposed a system only slightly differing from the one which was ultimately adopted. The Committee rejected the scheme on three grounds :

(*a*) any system without a visible gold currency would be looked upon with distrust.

(*b*) Flow of capital to India would be checked[2].

(*c*) India's gold standard would come to be based on a few millions of gold (or rather command over gold) kept in London.

Mr. Lindsay had always maintained that "they *must* adopt my scheme despite themselves" and he was right.

The Gold Exchange Standard system was worked in India by the sale of Council Drafts and Reverse Council Drafts. Council Drafts or Rupee Drafts were orders by the Secretary of State to the Government of India to pay rupees. These orders might be sent by post when they were called Council Bills or in a telegraphic form when they were called Telegraphic Transfers. These "orders" were sold to British banks, firms and importers in exchange for sterling (i.e., British money) received from

[1] Before the establishment of Imperial Bank in 1920 there were three Presidency Banks, in Bombay, Bengal and Madras.

[2] Presumably due to the distrust and uncertainty of foreign investors about the return on their investments in the absence of an effective gold standard.

them. The net result of the sale of Council Drafts was that the Secretary of State received sterling and the Government of India released an equivalent amount of rupees. The rate at which Council Drafts were to be sold was announced by the Secretary of State. Council Drafts had been sold even before 1893 but only to the extent to which funds were required by the Secretary of State to meet certain expenses (called Home Charges) on behalf of the Government of India. Instead of British importers of Indian goods sending sovereigns to India, people tendering them to the Government in exchange for rupees and the Government of India sending them back to London to meet their Home Charges, sovereigns were received by this method by the Secretary of State directly from British importers, the Indian exporters being paid in rupees. After 1893, however, the sale of Council Drafts was extended beyond the requirements of Secretary of State and in 1904 the Secretary of State announced his willingness to sell Council Bills on India *without limit* at 1s. 4⅛d. : Re. By this means the balance of exports over imports could be paid for in London without the export to India on private account of more gold than was required by the people. By offering Council Bills in London the Secretary of State began to facilitate the course of Indian trade. He also got a lever by which he could prevent the rate of exchange from rising higher than 1s. 4⅛d. : Re. It is obvious that so long as the Secretary of State offered one rupee for every 1s. 4⅛d. received by him, no person wishing to

remit money to India would have paid more than 1s. $4\frac{1}{8}$d. for a rupee to any other person or bank nor would any one care to ship gold or sovereigns direct to India.

The sale of Council Drafts was one facet of the Gold Exchange Standard system, the other being the sale of Reverse Council Drafts. The Reverse Council Drafts or Sterling Drafts[1] were orders by the Government of India to the Secretary of State to pay sterling (i.e., British currency) in return for rupees received by them. The result of the sale of Reverse Council Drafts[2] was that the Government of India received rupees and the Secretary of State released from his funds sterling. The demand for Reverse Councils, unlike that for Councils, arose rarely, for Reverse Councils would be demanded only when the payments to be made abroad were larger than those made by foreigners to this country and this could happen only when imports were larger than exports. Reverse Councils were not sold below the rate of Re. : 1s. $3\frac{29}{32}$d.

By the sale of Councils and Reverse Councils, the exchange was prevented from deviating very much from a fixed rate—1s. 4d. : Re. It could fluctuate between 1s. $3\frac{29}{32}$d. and 1s. $4\frac{1}{8}$d. to the rupee.

To complete the explanation, a few words may be added about the funds out of which the Councils and

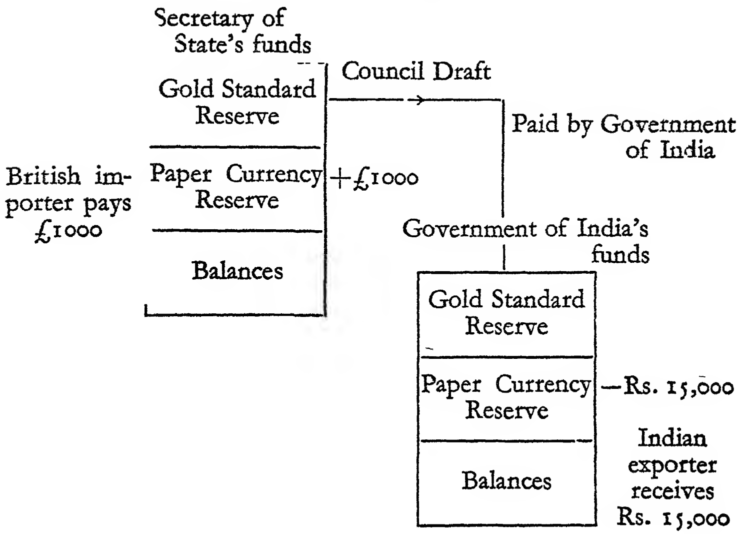
[1] So called because they were sold in a reverse direction to Council Drafts.

[2] Council Drafts and Reverse Council Drafts are often referred to shortly as "Councils" and "Reverse Councils".

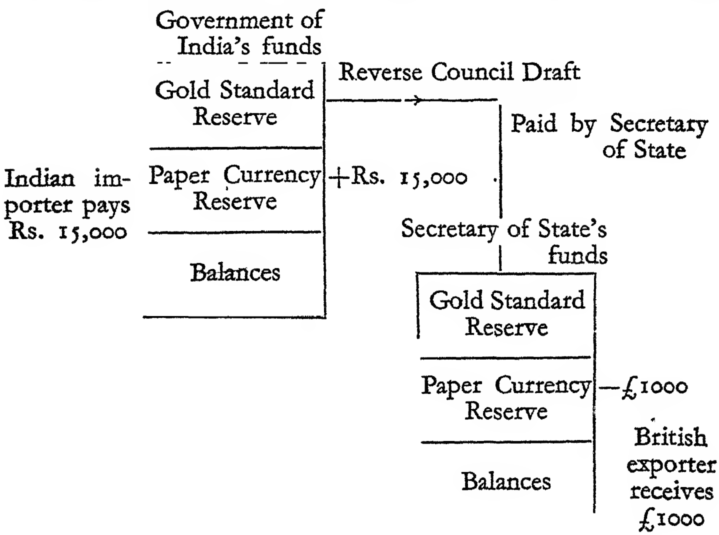
Reverse Councils were paid out. The proceeds of the sale of Councils were credited partly to the Secretary of State's balances, partly to Paper Currency Reserve held in gold in London[1], and partly to Gold Standard Reserve. The Councils were paid out of the Government of India's balances, the Indian portion of Paper Currency Reserve or rupee branch of Gold Standard Reserve. The proceeds of the sale of Reverse Councils were credited to balances or Paper Currency Reserve by the Government of India and they were paid out of balances or Gold Standard Reserve by the Secretary of State. Thus the balances, Paper Currency and Gold Standard Reserves (with their respective functions of meeting current requirements backing paper currency and meeting Reverse councils) were in practice used indiscriminately to maintain the exchange value of the rupee. The diagram given on the next page illustrates the mechanism of Gold exchange standard.

[1] The Paper Currency Reserve was the Reserve held against currency notes in circulation in India. The Act of 1861 provided for the issue of a maximum of Rs. 4 crores of currency notes against securities held as part of the Reserve, the rest of the Reserve being held in silver coin. By 1911 many changes had taken place in the composition of the Reserve. The amount of note-issue against securities had been raised to Rs. 14 crores and the Reserve had come to consist of, besides securities (both rupee and Sterling securities), gold coin and bullion and silver coin and bullion. It was held partly in England and partly in India subject to the proviso that all coined rupees were to be kept in India.

The sale of a Council Draft of £1000 (=*Rs.* 15000)



The sale of a Reverse Council Draft of Rs. 15,000 (=£1000)



The Chamberlain Commission, 1913

The views of the Chamberlain Commission about this system may be stated briefly. The Commission was appointed under the chairmanship of Mr. Joseph Austin Chamberlain in 1913 to enquire into the methods of maintaining exchange and the location and use of the reserves and balances and to report whether the existing practice was conducive to the interests of India. The Commission found the Gold Exchange Standard most suited to the conditions in India. They were of opinion that to encourage an increased use of gold in internal circulation was not to India's advantage and that the people of India neither desired nor needed gold as currency. There was no need of a mint for the coinage of gold but if Indian sentiment demanded it and the Government were prepared to incur the expense, one may be established for the coinage of sovereigns and half-sovereigns. If a mint cannot be opened, the Government should renew the notification withdrawn in 1906,[1] to receive gold at the Bombay mint in exchange for notes or rupees.

About Gold Standard Reserve they held that no maximum limit to its amount could be laid down but a much larger portion of it should be held in gold. The proper place for the location of the Reserve, they said, was London. The abolition of rupee (Indian) branch of the Reserve was recommended.

[1] See page 17, footnote 2.

The Paper Currency system, they recommended, should be made more elastic by issuing a larger amount of notes against securities.[1] The use of notes as part of the currency should be encouraged and 500 rupee note universalised.

The Commission also recommended that the Government should definitely undertake to sell bills in India on London at the rate of 1s. $3\frac{2}{3}\frac{9}{2}$d. per rupee whenever called upon to do so. (It may be recalled that during the crisis of 1907-08 they were sold only after considerable hesitation).

The report of the Commission was published in February 1914 and in July 1914 the war broke out. The Government could not, therefore, take action on most of the recommendations of the Commission but they abolished the silver branch of the Gold Standard Reserve and readily offered Reverse councils for sale when the demand for them arose at the outbreak of war.

§ 3. War and Breakdown of Gold Exchange Standard

The outbreak of the war in July 1914 caused in India a general dislocation of trade and business. Exchange

[1] The amount of note-issue against securities (fiduciary issue) could be increased only by resort to legislation and so a large metallic reserve had to be kept. This made a sudden and large increase in note-issue difficult for the Government, making the system of note-issue inelastic. The Commission recommended a larger amount of fiduciary issue.

became weak,[1] savings bank deposits were withdrawn, notes were presented for encashment in large quantities and gold was demanded in exchange for notes. All these were signs of panic and the Government took speedy action in dealing with them. To deal with the weak exchange, sterling drafts were sold to the extent of £8,707,000. Demand for withdrawal of savings bank deposits was met by continuous payments and about Rs. 8 crores were paid within a few months. Notes were readily encashed to the extent of Rs. 10 crores. The demand for gold in exchange for notes was met in the beginning but the issue of gold to private persons (i.e., apart from genuine trade purposes) was stopped on 5th August, 1914. All these prompt measures led to the restoration of public confidence by the beginning of 1916.

About the end of 1916, however, complications began to arise in the Indian currency system. The balance of trade began to turn abnormally in favour of India and during 1916-17, 1917-18, and 1918-19 the balance was much larger than the average pre-War balance. This was due to two causes: (*a*) increase in exports due to demand at high prices for raw materials and foodstuffs required for the use of the Allied Powers (*b*) contraction of imports from United Kingdom and her Allies and complete cessation of imports from Germany and Austria. Owing to this favourable balance of trade,

[1] This always happens due to capital being withdrawn from the country in panic and a loss of confidence in the currency.

a tendency was set up towards a rise in the rate of exchange and there was a heavy demand on the Government for rupees and currency notes. This heavy demand was further intensified by other payments that had to be made on behalf of the British Government, British Dominions and America for expenses of war in Mesopotamia, Persia etc. and for purchases made in India. The Government of India would not have been called upon to meet this heavy demand all by themselves if gold and silver had flowed freely into India as in pre-War years. Restrictions had, however, been imposed on the export of gold and silver by countries engaged in war and the world production of silver had also fallen. The burden of liquidating the balance of trade was thus thrown wholly on the Government.

The large purchases of silver by the Government of India, in order to meet the additional demand for currency, combined with a decrease in the world supply of silver and the increased demand from other countries, led to a rise in the price of silver. From 27¼d. per standard ounce in 1915 the price of silver rose to above 43d. per standard ounce in August 1917 and 55d. in September 1917. The price of 43d. per standard ounce deserves notice because at this price the exchange value of the rupee was equivalent to its bullion value. If the price rose higher than 43d. per ounce, the exchange value of the rupee could not be maintained at 1s. 4d. The rupee became worth far more than this in gold and if the Government

did not give more than 1s. 4d. in exchange for a rupee, the rupee itself would be melted or exported. With every rise in the price of silver above 43d., the government had to raise the rate of exchange accordingly. The Gold Exchange Standard which depended for its satisfactory working on the sale of Council Drafts without limit and on rupee remaining a token coin broke down. The exchange value of the rupee now began to move in step with its intrinsic value as it had done from 1873 to 1893.

The Gold Exchange Standard was an accidental find for India. It was almost a case of Jupiter going out to find fire and finding God. The system had received the praise and approval of Mr. J. M. Keynes and the Chamberlain Commission. India, they had seemed to say, had discovered a wonderful standard which lay in the "main stream of currency evolution."[1] India had been saved from the cruel fate of being crucified on the cross of gold. She could well spread her tails like a peacock to the sun. But now that the standard broke down, 'the enchantment was at an end, the mirage evaporated, the soap bubble burst and the chariot of Cinderella relapsed into its original pumpkins and mice!'

[1] J. M. Keynes: Indian Currency and Finance, p. 29.

CHAPTER V

IV Period: *August* 1917—1920

WARTIME REGULATION OF CURRENCY

§ 1. GOVERNMENT MEASURES TO REGULATE CURRENCY

In September 1917, the Government of United States took measures to control silver market and upto April 1919, the price of silver did not rise higher than 50d. per standard ounce. When the control over the silver market was withdrawn in May 1919, the price began to rise again. It rose to 58d. per oz. in May 1917 and to 78d. per oz. in December 1917. As the price of silver rose, the rate at which Council Drafts were sold had also to be raised. It was raised as follows—

28th August,	1917..1s. 5d.
12th April,	1918..1s. 6d.
13th May,	1919..1s. 8d.
12th August,	1919..1s. 10d.
15th September,	1919..2s.
12th December,	1919..2s. 4d.

To meet the demand for rupees, the Secretary of State for India purchased silver for coinage into rupees but the demand was so enormous that the ordinary market could not satisfy it and an approach had to be made to the Government of U. S. A. for a sale of silver

dollars in their reserve. In April 1918, the United States Government passed the Pittman Act authorising sale of silver from their reserve and the Government of India purchased 200 million fine ounces of silver. If this huge quantity of silver had not been received there might have been a serious currency crisis in India and the currency notes would have had to be made inconvertible into silver rupees.[1]

Besides raising the rate of exchange and purchasing silver, the Government of India also took measures to exclude private buyers from the silver market, conserve their stocks of gold and silver and to economise the use of silver. From 3rd September, 1917, the import of silver into India on private account was prohibited. The melting of silver or gold coin was made illegal in June 1917 and the export of silver coin and bullion from India was prohibited in September, 1917. Rs. 2½ and one-rupee notes were issued[2] and nickel coins of eight, four and two annas were put into circulation. On 29th June, 1917, an Ordinance was issued requiring all gold imported into India to be sold to the Government. Gold mohurs and sovereigns equivalent to 15 rupees were also coined and issued to supplement the currency. The fiduciary portion[3] of the note-issue was increased

[1] At one time in the year 1918, the rupees in the Currency Reserve available for encashment of notes amounted to a little more than 4 crores against a total note circulation of 115 crores.

[2] The issue of these notes was stopped from 1st January, 1926.

[3] The portion of note-issue not backed by metallic reserve but by securities.

from November 1915 onwards rising from Rs. 14 crores in 1911 to Rs. 120 crores in 1919 and restrictions were imposed on the encashment of notes. This led to a small discount or *batta* on notes in many parts of the country.

§ 2. A post-War Review

The Babington Smith Committee, 1919

All these measures were taken to cope with an unforeseen situation of great difficulty. As the tension created by the war relaxed, restoration of stability in exchange became necessary.

In May 1919, therefore, a Committee was appointed under the chairmanship of Sir Henry Babington Smith to examine the effect of the war on Indian exchange and currency system, to suggest modifications in it and to make recommendations with a view to ensure a stable exchange standard. These terms of reference precluded the Committee from considering or recommending any other system of currency.

The Committee emphasized the importance of stability of exchange for production and trade and recommended that the exchange value of the rupee be fixed at 2s. (gold) i.e., Rs. 10 : one Sovereign.[1] Two points about this recommendation deserve notice: firstly, a high rate of exchange was to be fixed and, secondly, the value of the rupee was to be fixed in terms of gold

[1] At this rate one Rupee = 11.30016 grains of fine gold.

rather than sterling. During the war, sterling i.e., British paper money did not remain equivalent to the gold it represented. It had depreciated in relation to gold. The Committee were in favour of linking the rupee to gold rather than depreciating sterling.

A high rate of exchange was recommended by the Committee to ensure that the rupee would remain a token coin. By making the rupee a token coin the Gold Exchange Standard could be made to function as before. The Committee favoured a high rate of exchange on other grounds also. A high rate of exchange would secure imports of goods at lower prices or at least check the rise of prices and thus reduce social and economic discontent.[1] It would have no adverse effect on exports of Indian goods because of the large world demand for Indian raw materials and foodstuffs. It would help industrialists, too; for it would keep down the prices of imported stores and machinery and by keeping low the cost of living check a rise in the wages of the workers. Finally, it would secure an economy in Home Charges; for a given amount of them could be remitted with a smaller number of rupees.

Mr. D. M. Dalal, a member of the committee, was opposed to the stabilisation of the rate at 2s. (gold) and wrote a minority report. He was in favour of main-

[1] If the rate of exchange be 2s. (gold) or Rs. 10 to one sovereign, 10 Rs. have to be paid for an imported commodity like cloth or sugar worth one sovereign; if the rate be lower, say, 1s. 4d. or 15 Rs.: £, the price paid is higher.

taining the old ratio of 1s. 4d.: Re. The rise in the price of silver was the chief argument for raising exchange ratio but Mr. Dalal held that the rise in the price of silver was artificial and could have been prevented by allowing export of silver from India after the War. He also believed that a rise in exchange ratio would cause set-back to several Indian industries and big losses to Indian exporters. It would also involve enormous loss to India on account of revaluation in terms of rupees of reserves invested in sterling securities and of gold held as part of the metallic reserve against the note-issue. Mr. Dalal regarded Gold Exchange Standard as unsuitable to Indian conditions and was generally in favour of abolishing the control exercised by the Secretary of State over Indian exchanges and removing restrictions on the free movement of gold and silver bullion to and from India.

The main conclusions and recommendations of the Babington Smith Committee may be set down as follows—

Those relating to stabilization of the Rupee

(*i*) It is desirable to restore stability of the rupee and to re-establish the automatic working of the currency system.

(*ii*) The exchange value of the rupee should be fixed in terms of gold rather than sterling and stabilized at 2s. (gold) or 10 Rs. to one sovereign (one rupee = 11.30016 grains of fine gold).

Those relating to restoration of automatic working of the system

(*iii*) Council Drafts may be sold by the Secretary of State in excess of his immediate needs, when a trade demand for them exists.

(*iv*) During periods of exchange weakness, the Government of India should be authorised to sell Reverse Councils without previous reference to the Secretary of State. Inconvenience and delay were caused by the necessity of consulting the Secretary of State beforehand and public confidence in the system was not ensured.

(*v*) The import and export of gold into and from India should be free from Government control.

(*vi*) The prohibition on the import of silver and import duty on silver should be removed as soon as convenient. The prohibition on the export of silver should be retained to prevent depletion of silver.

Those relating to use of gold currency

(*vii*) To encourage the increased use of gold in internal circulation would not be to India's advantage. Gold is best kept in Government reserves where it is available to meet demand for foreign remittance. Gold coins may, however, be issued in moderate quantities and sovereigns may be coined and issued.

(*viii*) The obligation of the Government to give rupees for sovereigns should be withdrawn but opportunities should be given to the public when introducing the new ratio to exchange sovereigns in their possession at the rate of 1£ : Rs. 15.

Those relating to reserves

(*ix*) Profits on the coinage of rupees should continue to be credited to Gold Standard Reserve, the amount of which cannot yet be fixed. The Reserve should contain a considerable proportion of gold, not more than one-half of the gold being held in India. The invested portion should continue to be held in London in liquid securities.

(*x*) The metallic backing behind paper currency in the Paper Currency Reserve should be fixed by law at a minimum of 40 percent of the gross circulation. The maximum for fiduciary issue should be retained at Rs.120 crores for a limited period. The portion invested in Government of India securities should be limited to Rs. 20 crores. To meet the seasonal demand for additional currency, notes upto Rs. 5 crores, over and above the fiduciary issue, may be issued as loans to the Presidency banks against export bills of exchange.

(*xi*) The silver and gold in the Paper Currency Reserve should be held in India except for transitory purposes.

CHAPTER VI

POST-WAR DEVELOPMENTS
(1920—1927)

§ 1. Failure of the Government Attempt to Restore Stability

V Period: February 1920—*September* 1920

The recommendations of the Committee were accepted by the Secretary of State in February, 1920, and various notifications were issued to give effect to them. It was notified that Council Drafts would be offered for sale at no fixed minimum rate and Reverse Council Drafts would be offered in future, if required, at a rate based on 2s. gold. War time restrictions on the import (but not export) of silver bullion, melting of silver coins and import and export of gold bullion and coin were removed. By the Indian coinage (Amendment) Act of 1920 the sovereign was made legal tender at Rs. 10.

About the beginning of February 1920 a keen demand arose for remittances to London owing to an enormous increase in imports and a fall in exports. Steps were at once taken to maintain the new exchange rate of 2s. (gold) by offering Reverse councils at a rate based on the sterling equivalent of 2s. (gold). The sterling

equivalent of 2s. gold could be calculated only from the dollar sterling rate.[1] As sterling was not equivalent to gold in England, its depreciation in relation to gold could be measured only from its ratio to dollar which was at par with gold. If the value of sterling in terms of dollar fell, the sterling equivalent of 2s. (gold) would rise and sterling-rupee exchange ratio based on 2s. (gold) would also rise. This may be made clearer by an example.

A definite quantity of gold = 4.8 dollars = one pound sterling = one sovereign = 10 Rs.

If sterling depreciates by 50% in relation to dollar then,

The same quantity of gold = 4.8 dollars = 1.5 pound sterling = one sovereign = 10 Rs.

As sterling depreciates, the same number of rupees begin to purchase a larger amount of sterling.

In the beginning of February 1920, the cross rate fell and the value of the rupee in terms of sterling rose. The Indian exporters fearing further rise began to sell their export bills. This accentuated the tendency towards a rise and the market rate reached 2s. 10½d. (sterling) on 11th February, 1920. After this, however, the sale of export bills fell off and the sterling value of the rupee began to fall. Three other forces began to operate to accentuate this tendency towards a fall—

(*i*) More rapid fall in the level of sterling prices

[1] Often referred to as London-New York cross rate.

than rupee prices.[1]

(*ii*) Unfavourable balance of trade which commenced in June, 1920.

(*iii*) Fall in the price of silver, the price in June, 1920 being 44d. per standard ounce.

The Government tried to maintain the rate at first at 2s. (gold). then from 24th June to 28th September, 1920 at 2s. (sterling), the market value of the rupee having fallen lower. The Reverse Councils sold at the above rates were/met by the sale of sterling securities and Treasury bills in the Paper Currency Reserve at prices much lower than those at which they were purchased. The amount paid out of Paper Currency Reserve, from the beginning of 1920 to the end of September was nearly £55.4 millions but the sterling value of the rupees purchased was only £25 millions. The loss to the Indian exchequer caused by the ill-advised attempt to maintain the rupee at 2s. amounted to Rs.40 crores. The Indian importers who had ordered goods from abroad expecting to pay one rupee for every 2s. also suffered serious losses owing to the failure of the Government to maintain the rate. They were also put to great hardship by the fall in prices and the rise in bank rate caused by the contraction of currency by the Government.[2] Many of them were driven to the verge of bankruptcy.

[1] The British Government had begun to deflate currency with a view eventually to make sterling equivalent to gold.

[2] Currency was contracted to prop up the tottering exchange ratio. When the supply of money in the market becomes less, the rate of loans rises. Currency contraction lowers prices also.

§ 2. Abandonment of Attempt to Maintain Stable Exchange

VI Period: 1920—1927

At the end of September, the Government suspended entirely the sales of the Reverse Councils. The intervention of the Government thereafter grew less but exchange was not left entirely to look after itself. It was only "managed on expedients different from those adopted before."[1] The Government continued to contract currency to attain some parity between internal prices and the falling world prices.

In 1921 the balance of trade was still against India and the rate of exchange which had fallen to nearly 1s. 5d. in December, 1920, fell still lower to 1s. 2⅞d. (under 1s. gold) in March 1921. In 1922, the balance of trade began to turn favourable to India and the sterling value of the rupee rose till it reached its pre-War level—1s. 4d. sterling—in January 1923. It rose to 1s. 6d. sterling (about 1s. 4d. gold) in October 1924 and the action of the Government was now directed towards preventing its rise above that rate.

A rise in exchange rate above 1s. 6d. sterling was prevented by the Government by introducing the practice of purchasing sterling in India. The purchase of sterling *in India* has the same effect as the sale of Council Drafts *in London* i.e., sterling is given by banks and firms

[1] Dr. Jain in the 'Monetary Problems of India' (p. 15).

in London for credit to the account of the Secretary of State and rupees paid to them in India. The advantages claimed for the system of sterling purchase are the following—

(*i*) The initiative in making remittances of sterling to London is transferred to the Government of India to whom it should rightly belong.

(*ii*) The purchases of sterling can be regulated with reference to the conditions of the Indian exchange market and heavy fluctuations in exchange rate avoided.

The system of purchase of sterling has gradually displaced since 1924 that of the sale of Council Drafts.

In pursuance of the recommendations of the Babington Smith Committee, changes were also made in the Acts governing the paper currency system. These were incorporated in the Consolidating Act of 1923, amended in 1923 and 1925. The Act laid down permanent provisions for the regulation of paper currency but as the permanent provisions could be carried into effect only after some time owing to the aftermath of abnormal war conditions, certain transitory provisions were also laid down. The *permanent provisions* were—(*i*) The metallic portion of the Reserve was to be at least 50 percent of the whole; (*ii*) The Government of India securities in the Reserve were to be Rs. 20 crores in amount and of these, the created securities were not to exceed Rs. 12 crores; (*iii*) the Governor-General-in-Council was empowered to issue currency notes upto Rs. 5 crores in amount against inland bills of exchange maturing with-

in 90 days.[1] This additional issue of currency could be made on payment to the Government by the Imperial Bank of India of a rate not lower than 8 percent. The amount of extra note issue was raised from Rs. 5 crores to Rs. 12 crores by an Amending Act of 1923 and in 1924 it was laid down that of these, Rs. 4 crores were to be issued when the Imperial Bank rate rose to 6 per cent and the remaining Rs. 8 crores when it rose to 8 per cent. *The transitory provisions were*: (*i*) the amount of securities in the Reserve was to be Rs. 85 crores (raised later to Rs. 100 crores in 1925), (*ii*) the Government were authorised to create securities (ad hoc securities) and issue them to the Controller of Currency but the amount of such securities was to be gradually reduced to Rs. 12 crores—the maximum amount permissible under permanent provisions.

[1]This provision was made to make the note issue more elastic in order to meet the seasonal demand for currency.

CHAPTER VII

THE HILTON YOUNG COMMISSION

VI period: 1920—1927—(*contd.*)

§ 1. The Recommendations of the Hilton Young Commission

In April 1925 England returned to gold standard and 1s.6d. sterling became equivalent to 1s. 6d. gold. In August 1925 a Commission was appointed under the chairmanship of Mr. Edward Hilton Young "to examine and report on the Indian exchange and currency system and practice, to consider whether any modifications are desirable in the interests of India and to make recommendations."

The report of the Commission was published in 1926. The three main recommendations of the Commission related to—

(*i*) The selection of a standard of currency.

(*ii*) The establishment of an authority to control the currency.

(*iii*) The rate at which the rupee should be stabilized.

The Commission made the following recommendations—

(*i*) Gold bullion standard should be adopted as

the system of currency. Gold coins should not be introduced into circulation but an obligation should be imposed by law on the currency authority to buy and sell gold in the form of gold bars without limit in exchange for rupees and currency notes. The legal tender quality of sovereigns and half-sovereigns should be removed. There should be no legal obligation on the Government to give rupees for currency notes.

(*ii*) The control and management of currency should be entrusted to a central bank (to be called the Reserve Bank of India).

(*iii*) The rate of exchange should be stabilized at 1s. 6d.

(*iv*) One rupee notes should be reintroduced and should be full legal tender.[1] Notes other than the one rupee notes should be legally convertible into legal tender money i.e., notes of smaller denominations or silver rupees *at the option of the currency authority*.

(*v*) The Paper Currency Reserve and the Gold Standard Reserve should be amalgamated. Not less than 40 per cent of the combined Reserve should consist of gold and gold securities.

Sir Purshottamdas Thakurdas, a member of the Commission, wrote a minute of dissent in which he emphasized that the change from gold standard to gold exchange standard in the past was "in absolute contravention of the currency policy officially adopted in 1899,

[1] See p. 38, footnote 2.

binding on the Government and the country." He, however, agreed with the gold bullion standard recommended by the commission *provided there was no interference with the free inflow of gold into India except with due publicity and the concurrence of the legislature.* He was of opinion that the demonetisation of sovereign and half-sovereign was unnecessary.

As regards a central bank he held that in the special conditions of India, the ends in view would be better served by developing the Imperial Bank of India into a full-fledged central bank. If, however, the shareholders of the Imperial Bank did not agree to a restriction of their dividends, there would be no alternative left but to start a new central bank.

As to ratio he disagreed that 1s. 6d. ratio was the *de facto* ratio and that prices, wages and finance had adjusted themselves to it. He recommended that the rupee should be stabilized at the rate which prevailed for nearly 20 years, viz., 1s. 4d. to the rupee.

The conclusions and recommendations of the Hilton Young Commission relating to currency standard, currency authority and exchange rate gave rise to acute controversy. These may be examined further in the next three sections.

§ 2. The Problem of a Monetary Standard for India

A sound monetary standard must satisfy certain essential requirements, such as simplicity, certainty and

stability and the suitability of the standard must be judged by the extent to which it satisfies them. The Hilton Young Commission had to select a standard that would meet these requirements. The choice had to be made out of four possible standards—

(*i*) the pre-War sterling exchange standard in a perfected form i.e., with its defects removed.

(*ii*) Gold exchange standard.

(*iii*) Gold standard with gold currency.

(*iv*) Gold standard without gold currency or gold bullion standard.

The Commission rejected the first three alternatives and recommended for adoption gold standard without gold currency.

Gold Exchange Standard: A Critique

The standard which worked in India from about the beginning of the present century to 1917 was in fact sterling exchange standard. Under it Indian currency was convertible into sterling but so long as pound sterling was convertible into pound gold it was as good or as bad as gold exchange standard. This standard worked fairly well and secured stability of exchange for about fifteen years. It had the merit of being cheap because gold did not circulate as currency. It had however, certain serious defects which may be described as follows :—

(*i*) It was not simple and intelligible to the people. The internal currency consisting of rupees and currency

notes was not convertible into anything tangible and visible (such as gold). It was convertible into sterling for making payments outside the country on those rare occasions when the balance of the trade turned against India. The working of the standard involved a good deal of Government control and interference and this did not inspire confidence in the minds of the people.[1]

(*ii*) It had resulted from a series of administrative notifications. It was not subject to any statutory regulation or control but depended for its working on a policy of the Government. There was, for example, no statutory obligation on the Government to sell Reverse Councils by which the rate of exchange was prevented from falling below 1s. 4d. The standard had thus no definite legal basis.

(*iii*) It depended for its satisfactory working on rupee remaining a token coin. If the price of silver rose above a certain point, the intrinsic worth of the rupee became greater than its exchange value and it became profitable to melt it or export it. The standard was thus subject to the danger of rupee disappearing from circu-

[1] "However complete the integrity and however great the intelligence on which official action is based, an automatic system which does not depend upon such action for its operation, is greatly to be preferred."—*Babington Smith Committee's Report*, *para* 35.

"We believe......that a pure exchange standard is no more and no less liable to manipulation than a gold standard; but that is not the opinion of the Indian public, and it is essential that whatever system of currency is adopted should be one that is capable of securing the confidence of Indian public opinion"—*Hilton Young Commission's report*, *para* 30.

lation. It broke down in 1917 when the gold price of silver rose above 43d. per standard oz.

(*iv*) It was a dependent standard because under it the internal currency was linked not to gold but to the currency of a foreign country. It was thus exposed to the currency and credit changes in England. As the Hilton Young Commission remarked, "there is undoubted disadvantage for India in dependence on the currency of a single country, however stable and firmly linked to gold."

(*v*) It was not automatic in its working because, it did not bring about automatic expansion and contraction of currency. The sale of Councils and Reverse Councils did not lead to an automatic expansion and contraction of currency. The expansion and contraction were regulated by the Government. In 1919-20-1921, for example, Reverse Councils of the value of more than £55 millions were sold and under an automatic system, internal currency of the value of about Rs. 47 crores would have been withdrawn from circulation. But the actual contraction amounted to only to a little over Rs. 34 crores. Similarly when Council Bills were sold, currency was not expanded to the same amount.

(*vi*) It was not elastic, i.e., it did not make a satisfactory provision for an increase in currency in busy seasons and times of financial crisis. When crops have been harvested and are moved, there arises an increased demand for currency but under the pre-War system this

could not be properly satisfied.[1] Nor was there any provision for an emergent issue of currency.

(*vii*) The two reserves—the Gold Standard Reserve and Paper Currency Reserve—which were kept to maintain the value of token currency were governed in practice by transitory provisions. Their functions also were confused and there was overlapping of the purposes for which they were maintained. The original function of the Paper Currency Reserve was to provide for the convertibility of notes into rupees and that of the Gold Standard Reserve was to maintain the external value of the rupee. In practice, however, the Reserves were used indiscriminately to maintain the external value of the rupee and notes. There was also duality in the control of currency and credit policy.

Most of these defects were pointed out by the Commission who concluded that an exchange standard whether based on sterling or gold would not remedy the defects of the Indian currency system.

Pros and Cons of Gold Standard with gold currency

Gold standard with gold currency had been demanded by the Indian commercial opinion as far back as the middle of the last century and the demand had been reiterated many a time since then. The Fowler Com-

[1]Currency could be expanded only by sale of Council Bills which would be demanded when goods were exported. There was no provision by which currency could be expanded to meet the demands of internal trade.

mittee recommended in 1898 a close approximation of gold standard with gold currency with a view to the "effective establishment in India of a gold standard and currency based on the principles of free inflow and outflow of gold." That aim was gradually deviated from and gold exchange standard came to be adopted. The Chamberlain Commission (1913) were not in favour of introducing gold currency but they conceded that "if Indian sentiment demands it and the Government of India are prepared to incur the expense," a mint for the coinage of sovereigns may be established, adding that "it is pre-eminently a question in which Indian sentiment should prevail." The Babington Smith Committee (1919) were precluded by their terms of reference from recommending any standard other than gold exchange standard. When the Hilton Young Commission was appointed in 1925, the question of a suitable standard for India came once again into prominence.

The officials of the Finance Department of the Government of India submitted to the Hilton Young Commission a scheme for the introduction of gold standard with gold currency. The scheme assumed that the management of paper currency and the conduct of Government remittances to London would be transferred to the Imperial Bank of India. The main features of the scheme were as follows—

(*i*) Gold coins and bank notes to be unlimited legal tender. Rupees to remain unlimited legal tender in the beginning but after some years to be made limited legal

tender to Rs. 50 only.

(*ii*) A statutory obligation to be imposed on the Government to give gold coin in exchange for gold bullion.

(*iii*) Bank notes to be payable on demand in gold coin.

(*iv*) A statutory obligation on the Bank to buy gold.

(*v*) A Reserve containing a certain percentage of gold and securities (gold and sterling) to be maintained.

(*vi*) The Imperial Bank to supply funds to the Secretary of State for meeting Home charges.

This scheme was to be introduced gradually over a period of about 10 years. It involved the sale of a large quantity of silver and the purchase of gold to the extent of about £103 millions.

The Commission rejected the scheme and the objections they raised against it are the main objections that would be raised against any proposal to introduce gold standard and currency in India. The grounds on which the scheme was rejected may, therefore be stated.

Objections to the scheme of gold standard with gold currency

(*i*) "A large extra demand (for gold) from India would cause increased competition for gold among the countries of the world and lead to a substantial fall in gold prices and a substantial curtailment of credit." India in common with other countries would suffer

from such fall in prices and curtailment of credit.[1]

(*ii*) The amount of gold that would be required for ensuring convertibility of notes and rupees cannot be accurately estimated. It is possible that people may begin to prefer gold coins to notes and to that extent notes would be replaced by gold coins. The fear of a fall in the status of the rupee may similarly bring out a huge number of rupees for conversion into gold coins. The actual demand for gold may thus turn out to be much greater than the estimated demand.

(*iii*) The fall in the demand for silver due to the adoption of gold standard would depress the price of silver. This would not only involve the sale of surplus silver at a low price but would also lower the value of the savings of poorer Indian people who invest their savings in silver ornaments.

(*iv*) The adoption of gold standard by India might lead to demonetization of silver by China also. This

[1]Gold is the basis of credit because in countries whose currency is convertible into gold, it is the backing behind the paper currency in circulation. If India purchased large quantities of gold to maintain them as a backing behind its paper currency, the demand for gold would increase. A rise in the demand for gold would raise its price in terms of commodities i.e., more of commodities would be given to get a certain quantity of gold. In other words, the prices of commodities in terms of gold would fall. A fall in prices would lead to depression in trade and India as a unit in the world trade system would suffer. An increased demand for gold from India would also mean that there would be less of gold available for other countries as a backing behind their paper currencies. This may necessitate contraction of paper currency with a view to maintain its convertibility into gold. And this would involve contraction of credit.

would raise the price of gold and depress the price of silver still further. In any case, the exchanges with China would be dislocated by any fall in the price of silver, China being a silver standard country. This would affect adversely trade with China, 'the only great, undeveloped market left for the expansion of international trade.'

(*v*) It would not be easy to obtain the large amounts of gold without the co-operation of Great Britain and U. S. A. and both the countries viewed with alarm the prospect of a large demand for gold from India in as much as as it would upset world prices.

(*vi*) The scheme would prove costly and though the cost could not be estimated accurately, it would be considerable. It might be in the neighbourhood of Rs.3 crores a year for about 10 years.

To these objections of the Commission may be added a few others which apply to gold standard and currency in general (rather than to any particular scheme of it).

(*vii*) Gold currency standard is expensive in that it involves the circulation of a very costly metal as currency. It would be better by far that gold should remain in the reserves to lend stability to exchange.

(*viii*) Gold currency is "a sign of backward civilization" and an "obsolete ideal". Many countries which returned to gold standard after the last War did not introduce gold currency.

(*ix*) The bulk of internal transactions in India

involve small payments for which rupees rather than gold coins are required by the people. Gold coins will therefore be of no use unless they are of very small value.

As there has been an insistent demand in this country for gold standard with gold currency, it is necessary to know the reasons for which it was favoured.

Merits of Gold Standard with Gold Currency

(*i*) Gold standard with gold currency is an automatic standard and prevents undue government interference with currency and exchange. Under it the inflow and outflow of gold are free and by producing their reaction on prices set into operation the natural correctives to fluctuating exchange.[1]

It is however, difficult to say if the standard would work automatically in India. If the imported gold is hoarded by the people and thus 'sterilised', prices may not rise and if gold does not come out of circulation for being exported when the balance of trade is against India, prices may not fall.[2] The natural correctives to ex-

[1] When exports exceed imports, the rate of exchange tends to rise and gold begins to flow into the country. Normally the gold will be handed over to the currency authority in return for internal currency. The expansion of currency will result in raising internal prices. The rise in prices will make the country a good market to sell goods in and a bad market to buy goods from, thus increasing imports and checking exports. The initial tendency towards a rise in exchange rate set up by an excess of exports over imports will thus be arrested. A similar corrective will begin to operate if exchange tends to fall due to the excess of imports over exports.

[2] "All experience goes to show that, so long as the public have the option of making payments in tokens or in gold, it is the surplus

change will not then operate. This is, however, on the assumption that the hoarding habit of the people will persist even after the introduction of gold currency.

(*ii*) The introduction of gold currency would discourage the uneconomic habit of hoarding gold. It would make the rural masses familiar with gold coins and hold out the assurance that all other forms of currency being convertible into gold are as good as gold.

The Hilton Young Commission differed from this view and held that "the mere act of putting gold into circulation would not......develop the banking and investment habit." What was needed, they said, was confidence in the stability of currency.

(*iii*) Gold standard with gold currency would inspire confidence of the people because the backing behind currency would be visible and tangible, much more so than under any other form of gold standard.

(*iv*) The Indian people do want gold in circulation, as is evident from the large absorption of imported sovereigns from 1900 to 1914. Besides, the 'weight of good academic opinion' is in favour of gold currency and 'this is pre-eminently a question in which Indian sentiment should prevail.'

(*v*) Gold currency is a stage in currency development towards an ideal system under which currency would be convertible into gold but gold coins will not

tokens and not the gold in circulation which will seek an outlet at a time of weak exchange"—*The Chamberlain Commission's Report*, para 62.

circulate on any appreciable scale. India will have to pass through this stage.[1]

Gold Bullion Standard as recommended by the Commission

The Commission recommended gold bullion standard, as they called it, for adoption by India. The main features of the standard were the following—

(*i*) An obligation was to be imposed on the currency authority to buy and sell gold at a certain fixed rate and in quantities of not less than 400 fine ounces (= 1065 tolas). In other words, the rupees and currency notes were to be made convertible into gold bars weighing not less than 400 fine ounces. There was to be no limitation as to the purpose for which gold was required but the conditions as to the sale of gold were to be so framed that normally the currency authority would not be called upon to supply gold for non-monetary purposes.

(*ii*) Sovereign and half-sovereign were not to remain legal tender,[2] but the rupee was to continue to be full legal tender.

(*iii*) Government Savings Certificates were to be

[1] Sir Basil Blackett's address before Delhi University in 1926, para 15.

[2] They were made legal tender by the Act No. XXII of 1899 (see p. 22). Their demonetization was necessary to secure automatic contraction and expansion of currency. Gold coins in circulation by taking the place of rupees and notes would prevent the automatic working of gold bullion standard.

issued to bring home to the masses that gold was the standard of value and that gold and rupees were mutually convertible. People could purchase these certificates and invest their savings in them. After three or five years, they could receive the principal along with the interest in rupees *or* gold *at their option.*

(*iv*) The existing currency notes were to remain convertible into rupees but the new notes to be issued were not to be legally convertible into rupees. Facilities for conversion of currency notes into rupees were, however, to continue to be provided.

(*v*) One rupee notes which would be full legal tender but not legally convertible into rupees were to be issued.

(*vi*) Gold Standard Reserve and Paper Currency Reserve were to be amalgamated.

The effect of the adoption of this system would be that (*a*) internal currency would consist of tokens —rupees and currency notes and (*b*) currency notes would not be convertible into rupees but both currency notes and rupees would be convertible into gold bullion.

Many advantages were claimed for the system by the Commission. *Firstly*, it would secure stability of exchange by ensuring convertibility of currency into gold at a fixed rate. *Secondly*, it was simple and certain because the backing behind the currency was one of gold into which internal currency would be convertible. It would, therefore, inspire confidence of the people. *Thirdly*, it was automatic because currency

would be expanded when gold bars are given to the currency authority to obtain notes or rupees and would be contracted when notes or rupees are given to the currency authority to obtain gold bars. *Fourthly*, gold would remain in the reserves and costly gold currency would not be introduced into circulation. *Fifthly*, it would pave the way for the introduction of gold currency at some future date if it was thought desirable to do so. Gold currency could be introduced when sufficient gold had accumulated in the Reserves.

The gold bullion standard recommended by the Commission was not fullfledged gold standard. The backing behind internal currency was not very tangible for ordinary people. Only bankers and bullion brokers could take advantage of the facilities for obtaining gold bars of 400 fine ounces (400 ounces = 1065 tolas = Rs.23000 (approximately) at the price proposed to be fixed). The device of the sale of Savings Certificates was, therefore, recommended by the Commission for bringing home to the people the change in the previous system. The conditions laid down for the sale of gold were such that gold would not be demanded by the people from the currency authority at all. Owing to certain difficulties pointed out by the Commission,[1] gold currency standard could not be adopted forthwith. Under the circumstances, the gold bullion standard though not conforming to the proper definition of gold

[1] The most important being the opposition of Great Britain and U. S. A.

bullion standard[1] was not an unsatisfactory system to be adopted and worked.

§ 3. The Question of a Monetary Authority

The Hilton Young Commission found unsatisfactory the existing system of monetary control under which the Government controlled the currency and the credit was controlled in as far as it was controlled at all, by the Imperial Bank. This divided control of currency and credit prevented co-ordination of currency and credit policies. It also kept the banking and currency reserves of the country separate, thus diminishing their capacity to be used in the most effective manner for the stabilisation of exchange.

To bring about unity of policy in the control of currency and credit, the Commission recommended the establishment of a central bank, to be called the "Reserve Bank of India". It was to be a share-holders' Bank with a capital of Rs. 5 crores. Its management was to be conducted by a Central Board consisting of 14 members of whom 5 (including the Managing Governor and Deputy Managing Governor) were to be nominated by the Governor General in Council. To eliminate the danger of any political influence, no member of Governor General's Council, Provincial Governments and Central and Provincial Legislatures was to be appointed

[1] See Prof. B. R. Shenoy's article in *The Indian Journal of Economics*, October, 1933.

President or Vice-President of a Local Board of the Bank or nominated as a member of the Central Board. The representatives of the commercial banks were to be ineligible in the same manner.

The proposed Reserve Bank of India was to perform all the functions of a central bank. It was to make and issue bank-notes, receive deposits from and collect money for Central and Provincial Governments, banks and bankers and give loans to and make remittances on behalf of the Central and Provincial Governments. It was to maintain the external and internal stability of purchasing power of the rupee. It was to buy and sell gold at a fixed rate in quantities of not less than 400 ozs. By taking over the remittance operations of the Government, the bank was to displace the Government from the exchange market. It was to take over the management of Gold Standard Reserve and Paper Currency Reserve (which were to be amalgamated into one) and pay a share of its profits to the Government of India. Finally, it was to act as bankers' bank.

The Reserve Bank of India was thus to be the monetary authority to work the gold bullion standard recommended by the Commission.

The Commission were against entrusting central banking functions to the Imperial Bank of India which in their opinion had useful work to do extending commercial banking facilities in the country. Sir Purshottamdas Thakurdas who wrote the minute of dissent held, however, that the Imperial Bank would not be

hindered in its commercial business if it was entrusted with central banking functions. He thought that the proposed Reserve Bank would be a rival institution to the Imperial Bank. He recommended the evolution of the Central Bank from the Imperial Bank. If, however, the share-holders of the Imperial Bank were opposed to their rights being restricted in the matter of getting their dividends, there would be, he said, "no alternative left but to start a new Central Bank."

§ 4. The Ratio Question

The Hilton Young Commission considered the time fully ripe for the stabilisation of the rupee and recommended that the rupee be stabilised forthwith in relation to gold at a rate corresponding to an exchange rate of 1s. 6d. for the rupee. The value of the rupee, they said, should be fixed in terms of gold and the rupee should be equivalent to 8.47512 grains of fine gold.[1]

The Commission pointed out the advantages of adopting 1s. 6d. ratio as well as the disadvantages of reverting to the pre-war 1s. 4d. ratio. The arguments given by the Commission *in favour of* 1s. 6d. ratio have been set down below.

1. At the existing 1s. 6d. ratio,[2] prices in India "have attained a substantial measure of adjustment with world prices and any change in the rate would mean a

[1] One gold pound contains 113.0016 grains of gold. 8.74512 grs.=3/40 of gold pound=1s. 6d. (gold).

[2] The exchange rate had been 1s. 6d. (gold) since June 1925.

difficult period of readjustment, involving wide-spread economic disturbance". Since June, 1925, exchange had been steady and the rupee prices and world prices had been falling together, showing that adjustment between exchange and prices had taken place. This conclusion was further confirmed by the absence of any adverse reaction on Indian trade.

2. Wages also have adjusted themselves to the prices at the existing exchange rate of 1s. 6d. Though there is depression in jute industry and cotton mill industry, it is due to causes which the manipulation of exchange rate cannot remedy.

3. As regards contracts, least injury will be caused by adhering to 1s. 6d. ratio. It is true that land revenue and other long term contracts were settled when the ratio was 1s. 4d., but owing to the rise of prices since 1914, the incidence of land revenue as calculated in terms of commodities has become lighter. The contracts concluded after 1918 could not have been on the basis of 1s. 4d. rate which was effective only for a very short period after 1918. As most of the contracts must be short term contracts, least injury would be done by adopting 1s. 6d. ratio.

The Commission gave the following *arguments against reverting to 1s. 4d. ratio.*

1. Though 1s. 4d. rate has been described as the 'natural' rate, it is difficult to understand in what sense it can be so described. If the Indian exchange were left to itself, there would be wide fluctuations in it and it

would be impossible to find out the "natural" rate.

2. 1s. 4d. rate would not be easier to maintain in times of adverse balance of trade, as has been argued by its supporters.[1] If the reserves are adequate as they would be, 1s. 6d. ratio can be made as effective as 1s. 4d. ratio.

3. It has been suggested that the stabilisation of the rupee at 1s. 4d. (Rs. 15 = one pound; gold) will raise the price of gold and check the abnormal import of gold into India for being hoarded. But the import of gold is due to causes (such as the people's appetite for gold) which can not be removed merely by adopting a lower ratio.

4. It is argued that if world prices fall in future 1s. 4d. rate will cause less rapid fall in Indian prices than 1s. 6d. rate. But any abnormal price fall in future is not expected and any prolonged fall in prices will react on Indian price level whether the rate is 1s. 4d. or 1s. 6d.

5. 1s. 4d. rate was not effective from 1917 to 1925 and it can not be contended that there has been an adjustment of prices and wages to that ratio. As there has been no such adjustment to 1s. 4d. rate, the fixing of this rate will lead to profound disturbance in economic conditions. It will lead to a rise in prices, causing hardships to consumers and wage earners. It may also by raising cost of living lead to a demand for higher wages

[1] The argument probably was that at 1s. 4d. ratio, less of gold would have to be given out of the reserves in return for a rupee, when the internal currency was converted into gold.

and salaries.

6. The reversion to 1s. 4d. ratio will upset the finances of the Government of India. Increased taxation may become necessary to meet the sterling obligations of the Government. If the budgetary equilibrium is upset, the credit of India as regards borrowing may also be impaired.

The Minute of Dissent

Sir Purshottamdas Thakurdas dissented from the conclusions and recommendations of his colleagues in favour of 1s. 6d. ratio. His *arguments against 1s. 6d. rate* have been summarised below.

1. The Government of India had been aiming at 1s. 6d. rate and, therefore, instead of stabilising the ratio at 1s. 4d. gold in September, 1924, as they ought to have done, they contracted currency, or unduly limited its expansion, to push up the value of the rupee to 1s. 6d. 1s. 6d. rate had thus been secured by currency manipulation and was not a "natural" rate.

2. There had been no adjustment of Indian prices since the rupee touched 1s. 6d. gold in June 1925. Though Indian prices had fallen since June 1925, the fall had been in response to a fall in world prices and not due to an adjustment of rupee prices to the higher (1s. 6d.) rate. The full adjustment of rupee prices to 1s. 6d. rate was yet to come. If world prices fall lower as is expected, the fall in Indian prices would be accentuated because, besides the adjustment already due, further

adjustment would become necessary. This heavy fall in prices will hit Indian producers very hard.

3. There has been no adjustment of wages to 1s. 6d. ratio and such adjustment, if, it has to be enforced by lowering wages, "will entail a long and bitter struggle between Labour and Capital, with consequent disturbance in the economic organisation of the country".

4. Until wages get adjusted to 1s. 6d. rate—which will involve a long and painful process—the foreign manufacturers will enjoy a bounty of 12½ per cent.[1] This indirect help to the foreign manufacturers will intensify competition with Indian industries.

5. It has been argued that 1s. 6d. rate has had no adverse influence on Indian trade. In respect of exports, the absence of adverse influence is due not to the suitability of the rate but to successive good harvests and the low holding power of the Indian agriculturist (who must sell and export his produce in any case). As regards imports there has been slackness in the demand for imports—an indication of lower purchasing power of the masses—and it is due to 1s. 6d. rate.

6. The adoption of 1s. 6d. rate will be injurious to the debtor class. There is no justification for imposing an additional burden on a class already overburdened.

Sir Purshottamdas Thakurdas rested his *case for*

[1] At 1s. 4d. rate, a foreign article selling for Rs.15 in the Indian market will give to the foreign manufacturer one pound. At 1s. 6d. rate, the same article worth Rs.15 will give him 12½ per cent more.

reversion to 1s. 4d. rate on the following arguments:—

1. 1s. 4d. rate had been in force for about 20 years and it should not be changed unless it is absolutely unmaintainable or unattainable.

2. It will have no adverse influence on Indian finances because the loss in sterling remittances will be made up in other directions. In any case, the gain in respect of sterling remittances obtained from 1s. 6d. ratio will be at the expense of the producer who will have to accept fewer rupees for the produce he has to sell.

3. It will cause no hardship to those whose contracts were entered into before 1917 and they include the vast mass of Indian agriculturists whose interests deserve full consideration.

4. The adoption of 1s. 4d. rate will appreciably diminish the risk of a depletion of the reserves in times of an adverse balance of trade.

5. No other country, even in the most prosperous circumstances, has considered it just or advisable to adopt a rate of exchange higher than its pre-War rate. India also should revert to pre-War rate and thus establish public confidence in its currency system.

Sir Purshotamdas Thakurdas having ably put forward his case in favour of 1s. 4d. concluded on a note of apprehension saying that if 1s. 6d. ratio was accepted, "India will be faced during the next few years with a disturbance in her economic organisation the magnitude of which it is difficult to estimate but the consequences of which may prove disastrous."

§ 5. Government Action on the Commission's Report

The publication of the Commission's report in 1926 gave rise to strong controversy which centred for the most part round 1s. 6d. ratio. Steps were taken by the Government to give effect to all the three main recommendations of the Commission.

In January 1927, the Government introduced the "Gold Standard and Reserve Bank of India" Bill to give effect to the recommendations relating to the adoption of gold bullion standard and the establishment of the Reserve Bank of India. The Bill was referred to a Select Committee. There was a stout opposition by a majority in the Committee to the main features of the scheme incorporated in the Bill, that is, to the bank being a shareholders' bank and to the exclusion of members of legislature from its directorate. The majority of the Select Committee also wanted an Indian as the Governor or Deputy Governor of the Bank and recommended the coinage of gold mohars. Owing to differences between the Government and the opposition particularly on the question of directorate, the Bill was dropped finally in February, 1928. So neither the Reserve Bank of India could be established nor gold bullion standard adopted.

To give effect to the Commissions' recommendations relating to the stabilisation of 1s. 6d. ratio, the Currency Act of 1927 was passed. The Act established 1s. 6d.

(gold) ratio[1] by imposing statutory obligation on the Government (1) to purchase gold at Rs. 21/3/10 per tola in the form of bars containing not less than 40 tolas (15 ozs.) of gold and (2) to sell gold for delivery at Bombay *or* sterling for delivery in London in amounts of not less than 1065 tolas (400 ozs.) of fine gold (or the equivalent amount of sterling). The Controller of Currency had the option to sell either gold or sterling. The Act demonetized sovereigns and half sovereigns[2] but an obligation was placed on the Government to receive them at Currency Offices and Treasuries at their bullion value at the rate of 8.47512 grains of gold : Re.

The Act did not at all introduce gold bullion standard because the Government retained and actually exercised the option of selling, in return for internal currency, sterling for delivery in London. Strictly speaking, therefore, the standard adopted was sterling exchange standard. But so long as sterling was convertible into gold (as it was upto September 21, 1931) the standard was actually gold exchange standard. In a way therefore, gold exchange standard, criticised and discarded by the Hilton Young Commission, was resumed.

[1] An amendment to fix the ratio at 1s. 4d. was lost in the Indian Legislative Assembly by 65 votes against 68.

[2] See page 63, footnote 2.

CHAPTER VIII

VII Period: 1927—*September* 1931

ADJUSTMENT AND STRAIN

§ 1. PERIOD OF ADJUSTMENT (1927—SEPTEMBER 1929)

From 1st April 1927, when the Currency Act of 1927 was brought into force to September 1929, trade conditions in India were favourable, both exports and imports registering a rise.

Value of merchandise (including Government Stores)
(In crores of rupees)

	1926-27	1927-28	1928-29	1929-30	1930-31
Exports	311	330	339	319	226
Imports	241	261	263	250	173
Total value	552	591	602	569	399

The total value of exports and imports in the three previous years i.e., 1923-24, 1924-25, and 1925-26 was 600, 653 and 623 crores of rupees respectively.[1] The improvement in trade cannot be attributed to stabilization of 1s. 6d. ratio; it might have been in a large measure

[1] As prices of the articles of export and import vary from year to year, the course of trade is better shown by the following table made on the basis of declared values in 1913-14:—

the counterpart of much greater improvement in world trade. Perhaps a lower ratio would have communicated that improvement to Indian trade in greater measure.

The Calcutta Index No. of prices, however, showed a noteworthy decline:

July 1914=100

Year	Index No.
1926	148
1927	148
1928	145
1929	141

The exchange, in spite of temporary recovery now and then,[1] showed signs of weakness for the most part of this period. The measures taken by the Government to strengthen it were :-

(*i*) Raising the rate at which it was prepared to lend

Values of exports and imports on the basis of declared values in 1913-14 (*In crores of Rs*).

	1923-24	1924-25	1925-26	1926-27	1927-28	1928-29	1929-30	1930-31
Exports	240	250	246	228	248	260	263	235
Imports	120	137	143	156	181	190	189	157
Total Value ..	360	387	389	384	429	450	452	392

[1] It was strong from December 1927 to February 1928 and during October and November, 1928.

emergency currency to the Imperial Bank of India.

(*ii*) Sales of treasury bills in large amounts to prevent the outflow of funds.

(*iii*) Contraction of currency.

§ 2. Period of Strain (October 1929—September 1931)

After September 1929, India became involved in the world trade depression—a depression unprecedented in magnitude and intensity. The prices of both agricultural and manufactured goods began to fall, but the decline in agricultural prices was much heavier.[1] Indian exports therefore received a severe setback. The Indian exchange became definitely weak and the Civil Disobedience movement started in 1930 weakened it further by paralysing trade and industrial production and causing a flight of capital from India.

The Government issued Treasury Bills in large amounts and contracted currency by selling sterling[2] and meeting these sales by transfers from the Gold Standard Reserve and Paper Currency Reserve to the Treasury balances of the Secretary of State.

The measures taken by the Government to maintain 1s. 6d. ratio created stringency in the money

[1] From September 1929 to September 1931, the prices of exported articles fell by about 46 per cent and of imported articles by about only 17 per cent.

[2] From June to September 1931, Reverse Councils worth £14 millions were sold. From 1926-27 to September 1931, currency of about Rs. 138½ crores was withdrawn from circulation.

market[1] and accentuated the fall in prices. Strong protests against them were made by Indian commercial interests.

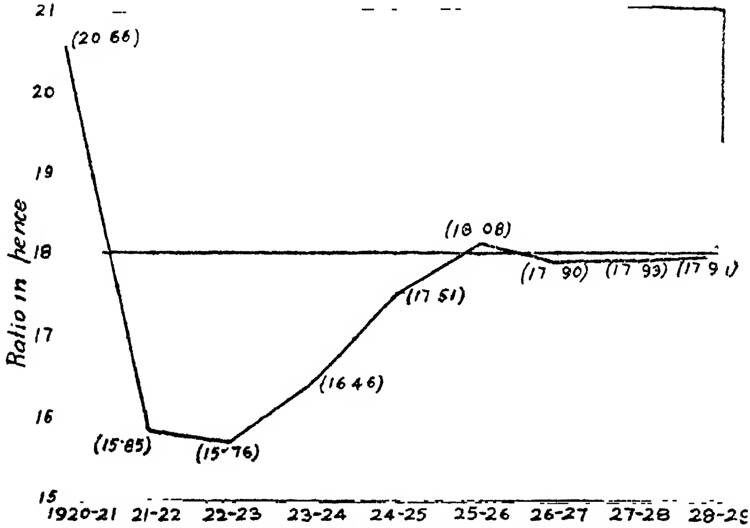
§ 3. Ratio in Retrospect

Examining the ratio controversy of 1926-27 in retrospect, it seems that the opponents of 1s. 6d. had better judgment on their side. It is true that there can be no such thing as a "natural" ratio because given a certain amount of deflation or inflation, any ratio can be accomplished for the time being and the internal price level will get adjusted to such a ratio. The argument for 1s. 4d. that it was the "natural rate" was meaningless. Nor should the case for 1s. 4d. have rested on its being the pre-War parity, for the decision to adopt a particular ratio has to be made with reference to the prevailing facts as regards prices, trade conditions, wages, etc. The economic conditions prevailing in India from 1927 to 1931 furnish no evidence that 1s. 6d. rate contributed to stability and progress. The two years 1927-28 and 1928-29 were no doubt years of comparative stability and expansion of trade. It is probable, however, that the stability or trade expansion was secured in spite of 1s. 6d. ratio. It was the Indian counterpart of increasing world stability and expansion of world trade. When

[1] The financial year 1928-29 opened with 7 percent bank rate. After a drop of 2 percent by November 1928 it rose to 7 percent in December, 1928, and to 8 percent in February 1929. (See the article by J. C. and H. Sinha in the Sankhya, December 1938).

the downward trend of prices and trade began, 1s. 6d. rate, which itself was never firm in the saddle, accentuated their fall in India. The Government refused to accept such a view.[1]

The following graph based on the average of the daily telegraphic transfer rates from Calcutta on London shows exchange fluctuations from year to year :—



[1] Sardar Sant Singh asked in the Legislative Assembly on September 9, 1931 for a statement on the loss caused to India by fall in prices due to action of Government of India in maintaining exchange at 1s. 6d.

Sir George Schuster replied: "I regret I do not understand the question. The fall in prices has been due not to the maintenance of exchange at 1s. 6d. but to the general world causes. If, for example, exchange had been fixed at 1s. 4d. in 1927, India would have felt the full shock of the fall in world prices for all her main commodities just as much as she is feeling it now. The percentage fall would have been the same."—*Legislative Assembly debates*, 1931, *Vol. V*, *pp.* 108-09.

CHAPTER IX

VIII Period : September 1931—1939

CRISIS AND AFTER

§ 1. LINKING THE RUPEE TO STERLING

On September 21, 1931, the British Government in consultation with the Governing Body of the Bank of England suspended sub-section *(ii)* of Section I of the Gold Standard Act of 1925. This sub-section laid an obligation on the Bank of England to give gold bars in exchange for internal currency. When this obligation was removed, sterling was divorced from gold and England was off the gold standard. Sterling, no longer convertible into gold, began to depreciate steadily in relation to it. It is not possible here to go into the causes of abandonment of the gold standard by England. Nor is it very necessary to do this to understand the reaction of that event on the Indian currency system.

The rupee was linked to sterling by the Currency Act of 1927 at the rate of 1s. 6d. but so long as sterling was convertible into gold the rupee was virtually on a gold basis. Now when sterling had no longer a fixed relation to gold the Government of India had to decide about the basis and the rate of the rupee afresh. Five alternative courses were open to them :—

(*i*) To link the rupee to sterling at 1s. 6d. i.e., to maintain the statutory obligation laid on the Government of India to sell sterling in exchange for internal currency at 1s. 6d. : Re.

(*ii*) To link the rupee to gold at 1s. 6d. rate i.e., to make the rupee convertible into gold at one rupee= 8.47512 grains of gold.

(*iii*) To link the rupee to gold at a rate lower than 1s. 6d.

(*iv*) To link the rupee to sterling at a rate lower than 1s. 6d.

(*v*) To leave the rupee free i.e., to link it neither to gold nor to sterling but to allow its exchange value to fluctuate according to its purchasing power relatively to that of other currencies and other market influences. This implied, of course, a kind of controlled inflation because left completely to itself, the exchange value of the rupee would fall to its bullion value.

Of these, the Government ultimately chose the first course. As soon as England went off the gold standard, the Governor General in Council issued an Ordinance (No. VI of 1931) removing the obligation placed on the Government by the Currency Act of 1927 to sell gold or sterling.[1] The position thus created was that the rupee was delinked from both gold and sterling.[2] Three

[1] The purchase of gold at the Mint was, however, not stopped.

[2] Mr. Arthur Moore asked in the Legislative on 21st September 1931, if steps would be taken to link the rupee with sterling during the period when it might be temporarily divorced from gold. Sir George Schuster replied that they have not had time to settle their

bank holidays were declared presumably to prevent a run on the banks by the public in an unreasoning fear.

A third event of outstanding importance which occurred on the same day i.e., the 21st September, 1931, was that the Secretary of State for India made a statement before the Federal Structure Sub-Committee of the Indian Round Table Conference informing them that it had been decided "to maintain the present standard on sterling basis."

On 24th September, 1931, therefore Ordinance VI was repealed and another Ordinance (No. VII of 1931)[1] was passed. This Ordinance restricted sales of gold or sterling to genuine trade purposes and reasonable personal requirements. The rules made under the Ordinance laid down £25000 as the maximum amount of gold or sterling to be sold to any recognized bank and empowered a Managing Governor of the Imperial Bank to call upon any recognized bank to satisfy him that it was purchasing gold or sterling only for purposes permitted under the Ordinance.[2] The object underlying all these restrictions was to maintain the sterling value of

detailed plans (Legislative Assembly Debates, 1931, Vol. V, Page 714).

[1] The Gold and Sterling Sales Regulation Ordinance, 1931.

[2] This does not mean that sales of gold were provided for by the Ordinance or a link with gold established. The position was that the Ordinance modified the Currency Act of 1927. The option of the Currency authority to sell gold *or* sterling remained but the amount of gold or sterling was restricted to £25,000. When the Ordinance was cancelled on 30th January, 1932, the Currency Act of 1927 came into force again.

the rupee at 1s. 6d. In the absence of such restrictions, it was feared, rupee would seek conversion into foreign currencies in large quantities, causing weakness in exchange.[1]

The action of the Government in linking the rupee to sterling was probably the best under the circumstances but it led to a good deal of criticism partly because it was taken without consulting the Indian Legislature or public opinion and also because the old ratio was maintained. The ratio question has been discussed in another chapter. As for linking the rupee to sterling, was any other course of action feasible?

The alternatives to a link with sterling were a link with gold and a "free" rupee. If the rupee had been linked to gold at 1s. 6d. or 1s. 4d. rate (i.e., made equal to 8.47 or 7.53 grains of gold), strong gold reserves would have been necessary to maintain the link. But at that time, the gold portion of the Paper Currency Reserve was very low and the gold stock amounted to £32½ millions sterling (£ sterling on its previous

[1] "………The Government of India, have had to take into account the possibility that in present conditions of uncertainty as to the international position, there might be an inducement to speculators to take advantage of unlimited facilities offered by the Government to acquire sterling exchange and that might operate to the detriment of genuine traders and of public interest." —*Sir George Schusters, statement in Legislative Assembly.*)

"In Bombay, in the first ten minutes after business opened and before the market were aware of the issue of the Ordinance, demands for 4,25,000 pounds sterling were received."—(*Sir George Schuster's reply : Legislative Assembly debates,* 1931.)

parity).[1] To maintain the convertibility of the rupee into gold at a time when there was rush for gold in other countries, deflation might have become necessary. Besides, a fixed ratio in terms of gold would have meant a fluctuating ratio in terms of sterling so long as sterling depreciated in relation to gold. A fluctuating sterling rate would have reacted adversely on India's trade with Great Britain and other countries which linked their currencies to sterling. If 1s. 6d. sterling rate was regarded as unduly high for India, 1s. 6d. gold rate (which meant much more than 1s. 6d. sterling) would have been still more objectionable.

A "free" rupee implied some kind of controlled inflation. It might have meant somewhat unstable exchange but in any case it involved greater currency control with some definite object or objects in view, e. g., raising or maintaining the internal price level in parity with costs. Such control requires initiative, foresight and boldness of action and does not offer the advantage of comparative stability. The Government wanted primarily an anchor for the rupee so that in paying off sterling loans and meeting other sterling obligations they might be relieved of the inconveniences and risks of an unstable exchange.

The linking of the rupee to sterling tied the rupee to the chariot wheels of depreciating sterling. In relation to gold or currencies based on gold, it depreciated along

[1] Sir George Schuster's statement in the Legislative Assembly on 24th September, 1931.

with sterling. The depreciation of the rupee raised Indian prices and tended to stimulate exports to countries having currencies based on gold and to discourage imports from them.[1] In actual fact, the stimulus to exports was in large part neutralised by declining world prices and high import duties and other restrictions imposed by most of such countries. As for imports from these countries, they became dearer in the Indian market and the British goods obtained an advantage in competition—a sort of preference by the back door. The advantage or preference was not enjoyed for long because other countries, too, either went off gold or devalued their currencies one by one. And this advantage would have accrued to Great Britain even if the rupee had been linked to gold.

The stabilization of the rupee in terms of sterling enabled the Government to meet its sterling obligations without embarrassment or uncertainty and led to marked improvement in India's credit.

The most important and probably the most far-

[1] An example would make this clear. If, before England went off the gold standard, one £ was equal to 4.86 dollars (gold), an American commodity worth 4.86 dollars could be purchased for one £ or Rs.13-5-4 (at 1s. 6d. rate). After England went off the gold standard, the pound sterling or paper pound was no longer equivalent to 4.86 dollars (gold); it became owing to depreciation equivalent to, let us say, 4.25 dollars (gold). In other words to purchase the same American commodity worth 4.86 dollars gold, more than one pound sterling had to be paid and since the rupee was linked to sterling at the old ratio more than Rs. 13/5/4 had to be paid. And for an Indian commodity selling for 4.86 dollars more than Rs.13-5-4 were received.

reaching effect of linking the rupee to sterling was the export of gold from India in huge quantities. The Government did not interfere with the export of gold which went on unchecked. An embargo or a high duty on gold exports or the purchase of gold by the Government was vehemently urged by those who considered export of gold injurious to the country.[1] The Government did not take this view and took no action and have taken none so far. The issues raised by gold experts are important and have been discussed below (§ 2). Only this may be mentioned here that the gold exports strengthened the exchange rate which consequently showed a tendency to rise above 1s. 6d. At a time when exports of merchandise had fallen and the balance of trade in merchandise had shrunk greatly, the gold exports created a large balance of trade in favour of India. The exchange became firm and during the next 4 or 5 years remained at a premium except for very brief intervals.

§ 2. Gold Exports

The issues raised by gold exports may be discussed under the following headings:—

1. The relation between gold exports and the linking of the rupee to sterling at 1s. 6d. rate.

[1] The Federation of the Indian Chambers of Commerce and Industry passed on the 26th March 1932, a resolution strongly urging on the Government of India 'the desirability of placing an immediate embargo on the export of gold from India' and 'the necessity of purchasing gold in the open market.'

2. The relative influence of economic distress and rise in the price of gold in causing gold exports.

3. The possible effect on gold exports of the adoption of an alternative course, say, linking the rupee to gold.

4. The economic implications of gold exports and of the measures that might have been taken to check them.

Owing to the economic distress caused by the heavy fall in agricultural prices during 1930-31, gold had begun to be sold by the people in rural areas much before England went off the gold standard. Mr. (now Sir) M. L. Darling, the Registrar of Co-operative Societies Punjab, who undertook a tour of the Punjab villages in the cold weather of 1930-31 found gold being sold to meet Government dues. "The following summer" he says, "the market price of wheat having fallen to Re. 1/6/- a maund, sale in canal irrigated tracts became very brisk......Even when the price of gold rose 50 percent, nearly all the gold that came upon the market from the village—and most of it came from this source—was distress gold, and those who were not obliged to sell, for instance, the larger land-owners, did not do so. In the town, too, it is only the very modern minded who are prepared to part with their ornaments for any other reason but necessity."[1]

[1] M. L. Darling: and *Wisdom and Waste in the Punjab Village*, pp. 320-21.

Another enquiry undertaken by the Punjab Board of Economic Enquiry in 120 Punjab villages also showed that the sales of gold were due to stern pressure of economic necessity[1]. No such information about other Provinces is available but it appears that upto September 1931 at least, gold was sold mostly out of necessity. A large part of it went ultimately into the hands of bullion dealers in the cities but a good deal was acquired by the Government also.[2]

After England went off the gold standard on September 21, 1931, and the rupee ratio was fixed in terms of sterling at 1s. 6d. the price of gold rose from about Rs. 21 per tola to Rs. 25 and in December 1931 stood above Rs. 30. At the same time export of gold from India commenced on a large scale and has continued ever since though in progressively decreasing amounts. The quantity and value of gold exported and the average price of gold are given below :—

[1] *Note on the sales of gold and ornaments in the Punjab villages.*
Chapter IV—"There is a mass of evidence coming from all parts of the Province to bear out the conclusion that necessity and economic pressure were the predominant forces behind the larger part of the sale of gold." P. 10.

[2] ".........Although we have lost a certain amount of our Currency Reserve in the last two months, we have not lost a single penny of our gold reserves and......our actual gold reserves stand at about £7 millions sterling higher than they did an year ago, owing to the receipts of gold from up country"—*Sir George Schuster in Legislative Assembly debates, September,* 1931.

	Net amount of exported gold (millions of fine oz.)	Value (crores of rupees)	Average price of gold per tola (in rupees)*
1931-32 ..	7.63	57.98	25.9.0
1932-33 ..	8.35	65.52	30.9.0
1933-34 ..	6.70	57.05	33.4.0
1934-35 ..	5.69	52.54	35.7.0
1935-36 ..	4.02	37.36	35.8.0
1936-37 ..	3.01	27.85	35.10.0
1937-38 ..	1.77	16.33	36.1.0
			(Nine months only)
1938-39 ..	1.35	13.05	†

* From Statistical Abstract for British India: 1927-28 to 1936-37.
† Figure not yet available.

Why did the price of gold rise? Why was gold exported? The price of gold in terms of rupees rose because sterling was depreciating in relation to gold and as the rupee was chained to sterling, it, too, depreciated. In other words as more sterling had to be given to get the same amount of gold, more rupees had also to be given.[1] The depreciation of sterling in relation to gold could be measured by its depreciation in relation to a currency still based on gold i.e., dollar or franc. The rupee price of gold, therefore, varied with fluctuations

[1] A small example would make this clear. Suppose on 19th September, one pound sterling was equal to 113 grains of gold. On 25th September, owing to depreciation of sterling, 1¼ pound sterling, let us say, became equal to 113 grains of gold. If the sterling ratio of the rupee remains the same, i.e., 1s. 6d., rupees 13-5-4 will purchase 113 grains of gold on the first date and Rs.16-10-8 the same amount of gold on the second.

in sterling-dollar rate and later, in sterling-franc rate.

It may be pointed out that even if the rupee had not been linked to sterling but left free, the price of gold in terms of rupees would have risen. The rupee would have depreciated in relation to gold and the rupee price of gold risen. Only if the Government had linked the rupee to gold at a definite rate, such a rise could have been avoided.

A rise in the rupee price of gold created a strong inducement for the people to sell gold. Those who were forced by economic necessity parted with it more freely and others who wanted to take advantage of its high price also sold it to convert their gold hoards into productive investments such as deposits in banks, purchase of land etc. The relative amounts of "distress gold" and "investment gold" must, however, remain largely a matter of conjecture. In both the cases the rise in the rupee price of gold brought gold out of the hoards in big amounts. But the *export* of gold from the country as distinct from its *sale* was due not to a rise in its price but to the difference between the sterling price and rupee price of gold. The sterling price being higher, the bullion dealers found it profitable to export gold. The fixed ratio of 1s. 6d. sterling helped this outflow of gold by keeping up this margin of profit while a rising exchange ratio would have extinguished it by bringing the bullion dealers less rupees in return for the sterling obtained for gold sold.

The exchange left to itself might have risen in

response to the stimulus of gold exports. A free rupee was one of the alternatives to fixed sterling rate. A "free" exchange would have been a rising exchange and though it would have checked gold exports, it might have completely disorganised trade. The only other alternative was to have linked the rupee to gold at a low rate, thus to have raised the rupee price of gold higher than its sterling price and made the export of gold unprofitable. The Government could then have purchased gold in the market at that price and sold part of it to pay off its sterling debts and to meet other obligations.

The whole position must, therefore, be examined with reference to the economic benefit or loss to the country caused by gold exports. If gold exports are beneficial on the whole, no criticism of the sterling link or ratio need be made on that account. If gold exports are injurious to the interests of the country, the measures that could be taken to check them, including a change in the basis or exchange value of the rupee, deserve consideration.

The case in favour of gold exports being left unchecked was ably put forward by Sir George Schuster, the Finance Member and other official spokesmen[1]. Gold is sold, they said, to tide over a period of exceptional difficulty and the Government are not justified in inter-

[1] Budget Speech, 1932, para 69-75. 1933, para 17-27—*Leg. Assembly Debates*, 1932, *Vol. II &* 1933, *Vol. II.*

The address by His Excellency the Viceroy to the Leg. Assembly, 1932—*Leg. Assembly Debates*, 1932, *Vol. I.*

fering with people's right to sell gold and reap the benefit of a high price. If gold hoards are not to be drawn upon by the people in hard times, what purpose do they serve? Besides it is far better that gold be taken out of hoards and relieve economic distress or get converted into profitable investment than that it should continue to lie barren and unproductive. Gold exports have also enabled the country to maintain a favourable balance of accounts and their quantity is small compared to the vast reservoir of gold built up in years preceding 1931.

Gold exports have enabled the Government to obtain large quantities of sterling and to pay off the sterling debt of £15 millions which matured on 1st January, 1932. They have also made it easy for the Government to meet recurring sterling obligations and to reduce the floating debt in India. The credit of the Government has, therefore, greatly improved and the rates at which the Government could borrow were substantially lowered. To cancel the sterling obligations by selling gold at a time when sterling price of gold was high was definitely a wise measure.

The position of the reserves has been strengthened by the addition to them of sterling securities. During the 15 months from September 1931 to December 1932 gold of the value of £80 millions was sold. External balances of currency of £80 millions were thus acquired of which the Government acquired £69¼ millions by open purchases in the market as currency authority. Out of this they used £34 millions for meeting current

requirements and £35 ¼ millions to reduce India's external obligations and strengthen the reserves.

These arguments in favour of gold exports may be reinforced further by others which support the official point of view. The export of gold strengthened the rupee-sterling exchange in particular and sterling in general. It stimulated Indian exports by raising the purchasing power of countries importing gold and also encouraged imports into India by enabling sellers of gold to purchase imported commodities. The sellers of gold made an enormous gain because they purchased it when it had a lower value in goods and rupees and sold it when it had appreciated in terms of both goods and services[1]. Above all, sterling "has had a more or less steady value in terms of goods", is a more secure international currency than gold and while the future price of gold is uncertain, sterling is appreciating in terms of other currencies[1]. It is highly improbable that gold will have the same position in the world's monetary systems (even if they go back on gold) as it had before and for India at least an independent standard—not a gold standard but a standard backed by moderate quantity of gold and aiming at internal stability—would be most desirable. It is better, therefore, to have sold out gold

[1] B. P. Adarkar: 'A Review of Gold Export Fallacies' in the *Indian Journal of Economics*, January, 1936, Paras 10, 12 & 21. Also A. D. Gayer: "The paper moneys of the Sterling area retained a remarkable steady purchasing power on the whole...... while gold underwent an outrageous appreciation in value".—*Monetary theory and economic stabilisation*, p. 195.

and invested part of it in interest bearing securities than to have retained it in the country as a dead asset.

Indian commercial and public opinion, was, however, opposed to unrestricted outflow of gold. An embargo on gold exports and the purchase of gold in the open market by the Government were urged by the Federation of the Indian Chambers of Commerce and Industry[1]. The main grounds on which the Government policy of non-interference with gold exports is criticised are four ; *firstly*, the Government has been parting with an appreciating commodity, gold, for a depreciating commodity i.e., sterling and the loss thus incurred is far in excess of any interest that may be earned on sterling securities ; *secondly*, it is doubtful if "the dethronement of King Gold from his proud position" has really been accomplished and so long as it is not accomplished there is an obvious advantage in retaining within the country a metal which the world may in future once again adopt as the basis of credit ; *thirdly*, if the Government had bought the gold and after selling a part of it to meet its sterling obligations retained the rest, they could have used it later to strengthen the banking reserves of the country and *fourthly*, if the price of gold rises in future due either to increased world demand for gold or decline in its production, the gold now exported would have to be purchased, if it was required, only at a loss.

[1] Resolution of the Federation of Indian Chambers of Commerce, dated 26th March, 1932.

The role of gold in the future monetary systems of the world is an important consideration in any discussion about gold exports. If gold is going to occupy the same position as before and the countries are to return to some form of gold standard, the Government policy of non-interference with gold exports justly deserves criticism. It may be pointed out, however, that even in the event of other countries returning to gold after building up their gold reserves, India may perhaps find it advisable to have an independently managed monetary system not based on gold. This brings us back to the old question: will any currency standard without a tangible gold backing inspire public confidence and will not, in the absence of such confidence, the uneconomic habit of hoarding continue? If the end in view is an independent monetary system managed with a view to internal stability, only a drastic remedy like the one proposed by Mr. B. P. Adarkar i.e., a liquidation of the entire stock of gold at an early date to be followed by prohibitive duties on both gold and silver,[1] can meet the demands of the situation. This negative remedy may be supplemented by a positive one i.e., the establishment of a network of some kind of savings banks adapted to the needs of rural people all over the country.

Leaving aside for the present the question of the monetary standard of the future,[2] it may be asked if the

[1] *Indian Journal of Economics*, January, 1936.
[2] See Chapter X, §2.

Government could retain gold within the country. If the rupee had not been linked to sterling, an embargo could be placed on gold exports and gold purchased by the Government. The Government could then have stabilized the rupee in terms of gold and sold the gold thus acquired to purchase sterling, which was progressively depreciating, to cancel sterling debts. The inflation caused by gold sales could have been neutralised to the required extent by raising loans in the market. A planned 'reflation' could thus have been undertaken.

After the rupee had been linked to sterling an interference with gold exports was unnecessary. The Government acquired sterling to pay off sterling debts and strengthened the reserves by purchasing sterling securities. Inasmuch as the rupee is linked to sterling, a definite advantage has been obtained by cancelling sterling debts and adding sterling securities to the reserves. One benefit of gold exports i.e., a rise in prices due to issue of fresh currency, has not, however, been obtained owing to the replacement of a part of gold in hoards by rupees and currency notes. and the rapid decline in commodity prices.

While an embargo on gold or Government purchase of gold had very little to recommend it after the rupee had been linked to sterling, the same cannot be said of a small export duty on gold. If the duty had fallen ultimately on the bullion dealers, it was amply justified and even if it had come out of the unexpectedly high price obtained by the seller of gold, it would have been un-

objectionable. The proceeds of such a duty could be utilised to relieve the economic distress in rural areas.

§ 3. Government's Sales of Silver

The export of silver from India was also stimulated by the abandonment of gold standard in September, 1931.[1] This was, however, small compared to the large quantities sold by the Government of India from 1927 onwards. The silver sales were undertaken in accordance with the recommendations of the Hilton Young Commission. The Commission held that when convertibility of notes into rupees was abolished under the system proposed by them and one rupee notes were introduced, big reserves of silver would be unnecessary. They, therefore, recommended that the unduly large stocks of silver in the Paper Currency Reserve should be gradually reduced from about Rs. 85 crores to Rs. 25 crores in about ten years. They also recommended that 'no favourable opportunity of fortifying the gold holding in the Reserve should be allowed to escape.'[2]

When the Commission reported there were 91 crores of rupees in the Reserve. The Government of India began to sell silver in 1927 and upto 31st March 1934, had sold a little over 196 million fine ounces of silver or about 57 crores of rupees. They still held 104 crores of rupees in September, 1933, i.e., there was an

[1] The report of the Controller of Currency, 1931-32, para 25.
[2] The report of the Hilton Young Commission, paras 78 & 80.

increase in stocks owing to the return of silver coins to the Reserve; for people had begun to substitute gold for depreciating silver in their hoards. A loss of about 33 crores was incurred by the Government on the sales. The proceeds of silver sales were utilized not to increase gold reserves but to meet current requirements.[1] The silver sales depressed the price of silver and also resulted in deflation of currency.

By the International Silver Agreement of July 1933, the Government of India bound themselves to sell not more than an average of 35 million ozs. (9 crores of rupees worth) annually for four years i.e., from 1st January, 1934 to 31st December, 1937. This coupled with the agreement of U. S. A. and other silver producing countries not to sell silver but to purchase 35 million ozs. annually stabilized the price of silver. During 1938-39, the price remained fairly steady varying between Rs. 48 and Rs. 53 per 100 tolas. The purchasing policy of the United States Government has been as before the main prop of the silver market.

§ 4. The Reserve Bank of India

The determination of the Government to maintain the sterling link of the rupee at 1s. 6d. was made clear beyond doubt in 1934 when the Reserve Bank of India Act was passed. The question of monetary standard

[1] "Out of the silver we have sold we have realized about £15¾ millions which has.........helped us to avoid borrowing......"—*Sir George Schuster's speech on 21st November, 1933.*

best suited to India was left to be considered when the international monetary position became clear and stable and the Reserve Bank of India was placed under a legal obligation to maintain rupee sterling ratio at 1s. 6d.

The establishment of the Reserve Bank of India in 1935 ended duality in the control of currency & credit. It gave promise of a new era of systematised currency and credit-control exercised to secure monetary stability. The constitution of the Bank bears most of the features incorporated in the Bill of 1927 which was dropped finally in 1928. The Bank is a shareholders' bank with an original capital of Rs. 5 crores divided into shares of Rs. 100 each. The risk of political influence entering the bank has been sought to be eliminated by making it a private shareholders' bank. The supervision and the direction of the Bank's affairs have been entrusted to a Central Board of Directors composed of sixteen members, one Governor and two Deputy Governors, twelve Directors and one Government Official. Of these the Governor and two Deputy Governors, four Directors and the Government official (i.e., eight members in all) are to be appointed by the Governor General in Council, the remaining being elected, but a Deputy Governor and the Government official are not entitled to vote. Salaried officials of the Government or Indian States, insolvents, people of unsound mind, bank employees and directors of banks other than co-operative banks cannot become Directors or members of a Local Board of the Bank but the Governor, Deputy Governor

and the Government official on the Central Board are eligible even if they are salaried officials, bank directors or bank employees.

The Reserve Bank of India will perform the functions of a central bank and transact such business as it has been authorized to transact by the Reserve Bank of India Act, 1934. It has the sole right to issue bank notes which will replace the present Government of India currency notes. The Reserve Bank notes are legal tender and are guaranteed by the Governor General-in-Council. Bank notes of the denominations of Rs. 5 and Rs. 10 were issued in January and February 1938 and those of Rs. 100, 1000, and 10000 later during the same year.

The Bank has to receive money and make payments on behalf of the Secretary of State and Central and Provincial Governments. It receives the cash balances of Central and Provincial Governments and carries out remittance, exchange and banking business on their behalf. It has been entrusted with the management of public debt and the issue of new loans. It can accept money on deposit without interest from and collect money for the Secretary of State, Central and Provincial Governments, local authorities, banks, and other persons. It can also make short term advances for periods generally not exceeding three months to Central Government, Provincial Governments, Indian States, local authorities, scheduled banks and Provincial Co-operative Banks. It can act as agent for the Secretary

of State, Central and Provincial Governments, States and local authorities for purchasing and selling gold and silver and bills of exchange, shares and securities and for collecting interest and dividends.

Besides these various kinds of business transacted for the Government, the Bank can purchase, sell and rediscount bills of exchange and promissory notes drawn on and payable in India or England. It can purchase and sell specified securities, gold coin and bullion. It can borrow money for a period not exceeding one month and enter into agency agreements with an international bank or central banks of other countries.

The Bank has been empowered to undertake open market operations, that is, on special occasions it can discount bills of exchange and make loans and advances directly and thereby expand, contract or stabilize credit. Normally the Bank will deal with scheduled banks and Provincial Co-operative banks and only on special occasions will it have to come into the open market i.e., deal directly with the public at large. Open market operations furnish a powerful instrument by which a Central Bank can regulate credit on emergent occasions.

The bank is under an obligation to maintain rupee-sterling rate at 1s. 6d. by buying sterling at a rate not higher than 1s. $6\frac{3}{16}$d. for a rupee and selling sterling for immediate delivery in London at a rate not lower than 1s. $5\frac{49}{64}$d. for a rupee. The amount of the sterling bought or sold is to be not less than £10,000.

The bank has an Issue and a Banking Department.

The liabilities of the Issue Department arise from the note issue and the assets of the Department consist of gold coin, gold bullion, sterling securities, rupee coin, rupee securities and bills of exchange and promissory notes payable in British India. Of the total amount of assets not less than 40 per cent is to consist of gold coin, gold bullion or sterling securities and the amount of gold coin and bullion is to be not less than Rs. 40 crores in value. Of the total gold coin and bullion not less than 85 per cent is to be held in British India. The Bank has taken over the whole of the gold coin and bullion in the Gold Standard Reserve and the Paper Currency Reserve and has assumed the liability of the currency notes of the Government of India. The liabilities and assets of the Issue Department on 31st December, 1938 are shown below—

Liabilities

	Rs.	a.	p.
Notes held in the banking Department	18,43,69,425	8	0
Notes in circulation—			
(*a*) Legal tender in India	1,80,25,68,317	8	0
(*b*) Legal tender in Burma only ..	7,73,91,350	0	0
Total notes issued ..	2,06,43,29,093	0	0
Total liabilities	2,06,43,29,093	0	0

Assets

	Rs.	a.	p.
A. Gold coin & bullion—			
(*a*) Held in India ..	41,54,53,252	0	8
(*b*) Held outside India	2,86,97,782	0	10
Sterling securities ..	59,50,02,401	8	3
Total of A ..	1,03,91,53,435	9	9
B. Rupee coin—			
Government of India rupee securities ..	32,32,39,048	10	0
Internal bills of exchange & other commercial papers	Nil		
Total Assets ..	2,06,43,29,093	0	0

Ratio of total of A to Liabilities: 50.339 *per cent*

The Reserve Bank of India is a bankers' bank and scheduled banks which numbered 57 on 31st December, 1938, have to maintain with it a balance amounting to at least 5 per cent of their demand liabilities and 2 per cent of their time liabilities. Demand liabilities generally mean deposits withdrawable on demand and time liabilities deposits repayable after some period. The maintenance of a balance of the Scheduled banks with the Reserve Bank is necessary because to make its policy effective, the Bank must have adequate resources and must be able to influence the credit policy of member banks.

The greatest difficulty in controlling the monetary system in India will arise from the existence of a vast mass of indigenous bankers and money-lenders who are responsible for about 90 per cent of the credit transactions. These bankers must be linked up with the Reserve Bank. In August 1937, the Bank formulated a Draft Scheme for the direct linking of private bankers but as the conditions laid down in the scheme, such as, closing other than banking business within a certain period and proper maintenance and audit of accounts, did not suit the indigenous bankers, nothing came out of it. Meanwhile the Bank is seeking information about the operations of the non-scheduled banks with capital and reserves of rupees 50,000 and over and trying to develop contacts with them. The Bank has also created, in compliance with its statutory obligation, a special Agricultural Credit Department to link its machinery

8

with rural credit agencies and to maintain an expert staff to study all questions of rural credit and give advice to governments and banks. A preliminary report of the Department on the main features of the rural credit problem was published in December, 1936. A full report was submitted to the Government in 1937 indicating the various directions in which improvements might be made to enable the rural credit agencies to render better service to the agriculturist and the manner in which the Reserve Bank could render assistance. The Department is at present engaged in an intensive study of problems relating to rural finance.

The Bank has to pay a part of its profits to the Government after meeting its expenses and paying a dividend fixed at 3½ per cent to the share-holders. The net profits and the amounts paid to the Government are as follows:—

In lacs of rupees approximately

Year	Net profits	Amount paid to the Government
1935 (nine months) ..	56.06	42.9
1936	53.42	35.9
1937	27.91	10.4
1938	38.45	20.9

In maintaining stability of exchange and regulating credit, the Reserve Bank of India must act in close collaboration with the Government of India, without

however, permitting any undue government interference. It must operate the currency and credit system of the country to its general advantage. The resignation of Sir Osborne Smith, the first Governor of the Bank, in 1936 owing to the differences (as the rumour had it) with the Finance Member of the Government of India and the appointment of a member of the Indian Civil Service as Governor are not conducive to the growth of sound traditions of central banking.

§ 5. Prices, Trade, Exchange and Finance (1931-39)

The fall in prices which commenced towards the end of 1929 was particularly heavy in the case of agricultural commodities. As India produces and exports largely foodstuffs and raw materials, the depression made a deeper mark on its economic life than on that of industrially advanced countries. The prices of both Indian exports and imports fell from 1929 onwards but the fall was much heavier in those of exports.[1] As the exports consist mostly of agricultural commodities and imports mostly of manufactured goods, the real terms of trade turned against India. In other words, the unequal fall in the prices of agricultural and non-agricultural goods left India worse off inasmuch as a larger quantity of exports was needed to get the same

[1] From September 1929 to June 1932, the prices of exported articles fell by about 47 per cent and of imported articles by about only 16 per cent.

quantity of imports in exchange.

Since 1929 there has been a continuous decline in the general level of prices as shown by the index numbers of wholesale prices. Both the Calcutta Index Number based on prices of 45 different commodities and the Bombay Index Number based on prices of 30 different commodities registered a decline as shown below—

Index Numbers of wholesale prices 1929 = 100

Year	Calcutta	Bombay
1930	82.3	86.9
1931	68.1	75.2
1932	64.5	75.2
1933	61.7	67.6
1934	63.1	65.5
1935	64.5	68.3
1936	64.5	66.2
1937	72.3	73.1
1938	67.6	69.5
January 1938	70.2	71.7
February ,, ...	68.8	71.0
March ,, ...	68.1	69.0
April ,, ...	66.7	69.7
May ,, ...	66.7	69.0
June ,, ...	66.7	69.0
July ,, ...	67.4	69.0
August ,, ...	66.7	69.0
September ,, ...	67.4	69.7
October ,, ...	67.4	69.0
November ,, ...	67.4	68.3
December ,, ...	67.4	69.7

The bottom of prices was reached in 1932-33 when the fall was a little less than 40 per cent compared to the level in 1929. There was some recovery in the next two years but it was in the latter part of 1936 that prices began to rise and the rise was almost continuous till August, 1937. After that the prices began to fall and were generally on the decline till the end of June, 1938 when they showed an insignificant rise which was more or less maintained till the end of 1938.

The agriculturists who form the bulk of Indian population were in acute distress on account of the heavy fall in prices up to 1932-33. "When the upward movement started in 1932-33 the rise in the prices of commodities in which he (i.e., the Indian agriculturist) was interested was painfully slow and halting."[1] With the exception of a short period extending from the middle of 1936 to about the middle of 1937, there has been no definite upward movement in the prices of primary commodities. Besides an almost constant low level of prices, trade restrictions and currency depreciation resorted to by most of the countries led to a shrinkage of Indian exports and deepened the misery of the Indian agriculturist. The misery has been relieved only to a limited extent by the trade agreements entered into by the Government of India with Great Britain in 1932 and 1935 and with Japan in 1934.

The value of both exports and imports having fallen

[1] Review of the Trade of India, 1937-38, page 12.

heavily after 1931, the balance of trade in merchandise in favour of India shrank rapidly. The actual position in respect of the total balance of trade was, however, masked by the heavy exports of gold which supplemented exports of merchandise. The table given on p. 111 shows the position in respect of exports and imports since 1931.

It may be noticed that while the total visible balance of trade in favour of India has been fairly large throughout, the balance of trade in merchandise fell as low as Rs. 3 crores in 1932-33, increased thereafter reaching a figure of about Rs. 78 crores in 1936-37 and has fallen again during 1937-38. For India excluding Burma, the balance of trade in merchandise and the total visible balance of trade were as follows—

In crores of rupees

Year	Balance of trade in merchandise	Total visible balance of trade
1935—36	+ 5.1	+40.5
1936—37	+51.2	+64.9
1937—38	+15.9	+30.2
1938—39	+17.4	+29.3

If gold exports had not taken place on a large scale, the total visible balance of trade in favour of India would have been very small and both the payment of foreign obligations and the maintenance of exchange would have been exceedingly difficult. Gold exports

In crores of rupees

Year	Value of exports of merchandise including re-exports	Value of imports of merchandise	Total visible balance of trade in merchandise	New exports or imports of treasure	Total visible balance of trade
1931—32 ..	160.55	125.72	+34.83	+55.65	+90.48
1932—33 ..	135.49	132.27	+ 3.22	+64.93	+68.15
1933—34 ..	149.73	114.99	+34.74	+57.23	+91.97
1934—35 ..	155.22	131.80	+23.42	+52.54	+75.96
1935—36 ..	164.29	133.69	+30.60	+36.37	+66.97
1936—37 ..	202.33	124.58	+77.75	+14.50	+92.25
1937—38 ..	202.63	159.18	+43.45	+15.11	+58.66
1938—39 ..	180.27	137.24	+43.03	+22.79	+65.82

Figures for Kathiawar and Travancore ports have been excluded. Figures for Burma have been included.

thus saved a very bad situation. They are, however, steadily falling off and the decrease in them has been more than made up by an increase in exports. The growth of exports has been almost continuous since 1933-34 but the course of imports has been somewhat erratic. During 1937-38 exports remained more or less steady but imports recorded a rise of about Rs. 35 crores. In the second half of 1937-38, there was an excess of imports over exports, in each month except October and February. One reason given for it is that "a lag of this kind is to be expected in a country such as India which exports mainly raw materials and imports mainly manufactured goods. Her exports are affected comparatively quickly by world prices and conditions but imports arranged during a time of prosperity continue to arrive after the upward trend has been reversed."[1] The large imports during the latter half of 1937-38 may thus be a "carry over" from a period of brisk trade preceding it. It is, therefore, difficult to say at present whether the increase in imports is due to temporary causes or represents a tendency. During 1938-39, both exports and imports registered a decline compared to 1937-38, the balance of trade being + Rs.66 crores against + Rs.59 crores for 1937-38.[2]

[1] The Reserve Bank Report on Currency and Finance, 1937-38, p. 3. Also the Review of the Trade of India, 1937-38, p. 69.

[2] There has been a comparatively greater fall in the values of goods imported since the beginning of 1938-39 which is attribut-

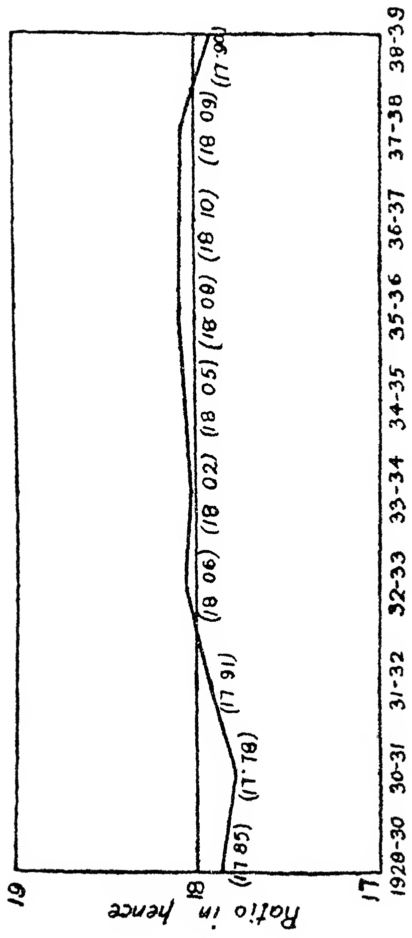
From September 1931 to 1935-36, gold exports kept the total balance of transactions largely in favour of India and the rate of exchange remained firm. Left to itself it might have even risen higher than 1s. 6d. During the last 3 years (i.e., from 1935-36 to 1937-38) also, the exchange remained firm but the firmness was due to a marked improvement in India's balance of trade in merchandise. Throughout the year 1937-38 as during the previous two years, the rate remained near the upper limit fluctuating between 1s. $6\frac{1}{8}$d. and 1s. $6\frac{3}{32}$d.[1] From April 1938, however, the effect of falling exports and increasing imports began to be visible on the exchange rate which began to fall and reached a point lower than 1s. 6d. in the first week of June 1938. On June 6, 1938, the Government of India issued a *communique* making it clear that "they are satisfied that the maintenance of the present value of the rupee is required in the interests of India and that the resources available for this purpose are more than ample" and pointing out that "the gold and sterling assets actually in the hands of the Reserve Bank and the Government of India are at the present time worth more than Rs. 160 crores." The Government announcement steadied exchange slightly but till the end of 1938, the rate did not rise higher than 1s. $5\frac{15}{16}$d. In the month of December

able partly to the reduction in the volume of imports and partly to the fall in prices.

[1] The Reserve Bank Report on Currency and Finance, 1937-38, p. 7.

forward exchange rates weakened and the Government issued another *communique* attributing exchange weakness to movements of funds to United Kingdom by speculators who wanted to bring them back at a profit when the ratio was lowered. They repeated their decision to maintain the exchange at the present statutory rate. During the last quarter of 1938-39, there was an improvement in the balance of trade and the exchange rate improved to 1s. $5\frac{3}{3}\frac{1}{2}$d. in March 1939. The graph, given on the opposite page is based on the average of daily telegraphic transfer rates from Calcutta on London and shows exchange fluctuations from 1930-31 to 1938-39.

The demand for a lower exchange value of the rupee has been pressed on the Government throughout the last seven years by important sections of commercial opinion. One after another England, Scandinavian countries, Egypt, Japan, United States, Belgium, France, Holland, Switzerland, Italy and Czecho-Slovakia depreciated or devalued their currencies and each addition to the list of devalued currencies created an alarm in India and renewed agitation in favour of a lower exchange rate. The large influx of Japanese imports during 1932 due to depreciation of Japanese yen had to be counteracted by the Government by raising high the import duties on cotton piecegoods of other than British manufacture. In 1933, some prominent businessmen and industrialists formed the Currency League of India "to educate and organize public opinion with a view to opposing the continuation of 18d. sterling ratio as is sought to be done


1928-30
30-31
31-32
32-33
33-34
34-35
35-36
36-37
37-38
38-39
(17.85)
(17.78)
(17.91)
(18.06)
(18.02)
(18.05)
(18.09)
(18.10)
(18.09)
(17.90)
17
18
19
Ratio in pence

through the Reserve Bank Bill and to bring about an immediate devaluation of the rupee." An amendment to the Reserve Bank of India Bill was moved in the Legislative Assembly to secure lower sterling exchange rate but was defeated. In October 1936 after the devaluation of franc and other currencies of the gold bloc, the Indian commercial interests grew apprehensive that India's export trade with these countries would receive further set-back while imports from them into India would be stimulated.[1] The failure of the Government of India to revise Indian currency and exchange policy in view of the devaluation of these currencies was discussed in the Indian Legislative Assembly on October 8, 1936. Recently in May 1938, the Prime Ministers of the Congress governed Provinces resolved to secure the co-operation of all the Provinces to send representations to the Government of India for devaluation of the rupee. This was a significant move showing that most of the Provincial Governments had come to regard 1s. 6d. ratio as injurious to Indian interests. The matter was taken up by the Indian National Congress which passed a comprehensive resolution on the subject on December 14, 1938. The policy of the Government has all along been clearly stated, it may be summed up in the words of the present Finance Member: "I will be no party to

[1] It was feared among other things that a devaluation of the guilder might reduce the protective value of the sugar tariff and facilitate imports from Java and that of dollar might encourage the import of American cotton into India.

any monkeying about the present ratio."[1]

The fall in prices and the shrinkage of trade along with internal political disturbances led to a fall in both Central and Provincial revenues during 1931-32 and 1932-33. To make up the deficiency in central revenue, both retrenchment and fresh taxation were provided for in the Supplementary Finance Bill of September, 1931. Most of the Provincial budgets also showed deficits and the Provinces which did not receive a square deal under the Meston Award felt the pinch most. Economy, retrenchment and taxation were all used to restore budgetary equilibrium but the sagging agricultural prices did not permit any substantial improvements in finances. Since 1933-34, there has been a definite improvement in the central finance but most of the Provincial Governments have been experiencing difficulties in balancing their budgets. Since 1937 these difficulties have become particularly acute in provinces under Congress Governments which are losing excise revenue owing to the gradual introduction of prohibition and are undertaking reforms involving increasing expenditure. Sir Otto Niemeyer's recommendations embodied in an Order-in-Council[2], provided for financial assistance to all the Provinces by cancellation and consolidation of debts, assignment of a share of the proceeds

[1] Sir James Grigg's reply to the address of Indian Merchants Chamber (August, 1935).

[2] The Government of India (Distribution of Revenues) Order, 1936.

of jute export duty (to jute growing provinces), grants-in-aid to some provinces and the distribution of a part of the yield of income tax among all the Provinces. The additional funds thus made available were readily absorbed in either filling up the gap in revenue or meeting fresh expenditure. In 1937-38 and 1938-39 sums of Rs. 125 and Rs. 150 lakhs out of the proceeds of income tax were distributed among the provinces and a sum of Rs. 178 lakhs was provided for distribution in the budget of 1939-40. Yet the Provinces want more funds and it is clear that no lasting benefit can be obtained by the Provinces without a substantial rise in agricultural prices and recovery in trade.

CHAPTER X

THE FUTURE

§ 1. The ratio controversy

Controversy about the correct rate of the rupee in terms of British currency is at least as old as the Fowler Committee of 1898. The Committee had to decide between 1s. 4d. and a lower ratio and though a majority recommended 1s. 4d. ratio, a minority argued in favour of a lower rate. The controversy arose again when the majority of Babington Smith Committee of 1919 recommended 2s. (gold) rate and Mr. Dalal wrote a strong minute of dissent. It has become acute since the publication of the Hilton Young Commission's report in 1926 and has centred round 1s. 6d. rate recommended by the Commission and given effect to by the Government. It may be noted that 1s. 6d. ratio of 1927-31 was virtually a gold rate and 1s. 6d. ratio of today is a sterling rate—a material difference, seeing that in terms of gold the value of the rupee has already fallen by about 40 per cent since September 1931.

The critics of 1s. 6d. ratio include important Indian commercial and agricultural interests besides politicians and economists.[1] They consider the existing ratio highly

[1] For a recent academic discussion of the ratio question, see

injurious to India and would have it reduced to 1s. 4d. sterling or even a lower figure if necessary. The demand for devaluation of the rupee was before September 21, 1931 a demand for lower value of the rupee in terms of gold but is now, when sterling has no longer a fixed relation to gold, a demand for lower value in terms of sterling.

The devaluation of the rupee involves so many issues and touches so many interests that one hesitates to venture a categorical pronouncement in favour of or against it. An attempt to understand these issues may be made by finding answers to four questions—

1. What should be the object or objects of currency policy in India?

2. How far can that object be achieved by currency policy alone (i.e., unaided by measures of another kind)?

3. Has stabilisation of exchange rate at 1s. 6d. failed to secure that object? What evidence is there that it has failed to do so?

4. If 1s. 6d. ratio has failed to do so, can devaluation of the rupee secure it? If so, what should be the extent of devaluation?

The objective of currency policy in India should be determined with reference to her economic position. India is a debtor country with a vast rural population, large internal trade and struggling industries. As a debtor country she has to meet foreign obligations

The Sankhyā, The Indian Statistical Journal, March and September 1937, and November and December, 1938.

amounting to more than £32 millions. An exportable surplus of merchandise of that amount at least must be maintained year after year. The alternatives are either to export precious metals or to raise foreign credits. The interests of the vast rural population demand that prices of agricultural produce should cover the expenses of agricultural production. The growing industries require protection from foreign competition and the large internal trade has to be saved from violent strains due to forces originating outside the country.

As a debtor country India must naturally attach great importance to the stability of the exchange value of the rupee. Small changes in exchange ratio may cause big differenees in the amount of foreign remittances. It cannot be maintained, however, that an exportable surplus to meet foreign obligations can under all circumstances be maintained by keeping exchange stable. Currency may have to be devalued and has actually been devalued by several countries to rectify an unfavourable or falling balance of trade. Otherwise, too, rigid stability of exchange is too narrow an objective for a country like India with a large rural population and internal trade. An exchange kept rigidly fixed is bound to be a good conductor of disturbances occurring in the outside world. It will expose internal economy of the country to the stress and strain of external forces. In the troubled world of today exchange rate has to be used as a "shock absorber" of price disturbances outside the country so that the prices inside the country may remain in level with costs

and production and employment may follow a steady course. For India the maintenance of stable cost-price parity is a much more desirable objective than mere stability of exchange. An exchange rate that secures adjustment between world prices and internal prices is not enough unless the internal prices are also brought into level with internal costs. It is obvious that no exchange rate rigidly clung to can secure that object.

It would be claiming too much for currency policy to say that it alone can secure stability of production and employment. Currency policy by itself cannot rectify all maladjustments in the economic organization of a country.[1] Yet it is a powerful instrument which if wielded at a psychological moment can 'stop the rot' caused by an incipient or even deep depression and stimulate industries and trade. In Australia this instrument was used to the best effect and admirable results were obtained. It is true that certain special conditions in Australia such as the greater flexibility of wages and, therefore, cost of production made currency devaluation effective. But good results can be secured elsewhere also if the devaluation is well-timed.

Ever since 1s. 6d. ratio was fixed in 1927, the Government have expressed, reiterated, affirmed and reaffirmed their determination to maintain it and have taken

[1] "The entire economic system cannot be controlled by operating a single lever, through monetary mechanism alone, but control of that lever is indispensable in the pursuit of balanced economic advance". A. D. Gayer in *Monetary Theory and Economic Stabilisation*, p. 195.

all possible measures to that end. In 1929-30 and 1930-31 they experienced difficulty in maintaining it and contracted currency to the extent of over Rs. 40 crores. The abandonment of gold standard by England relieved them of the task of maintaining 1s. 6d. gold rate. The linking of the rupee to sterling was a disguised depreciation in relation to gold. The pressure of inexorable forces thus made the Government adopt in September 1931, a course which they had refused to follow voluntarily. The heavy contraction of currency during 1929-30 and 1930-31 was justified by Sir George Schuster as a consequence of slackness in trade.[1] Even allowing for trade slackness, it appears that the currency contraction was made necessary by the attempt to maintain 1s. 6d. rate. Those opposed to 1s. 6d. ratio, therefore, pointed out that the maintenance of 1s. 6d. ratio had not only fully exposed Indian economy to world depression but actually intensified certain of its effects by accentuating the fall in internal prices.

It is difficult to say how far there has been an adjustment between prices and costs during the last 6 or 7 years and whether at present the rupee is over-valued. The statistics available in this country about prices and costs are neither very accurate nor very reliable. The information about changes in price level is based on Calcutta or Bombay index numbers of prices, the method of construction of which can be greatly

[1] Address to the Conference of Finance Secretaries, October, 1930.

improved. There are no statistics directly relating to costs of production and use is, therefore, made of Bombay cost of living index number and statistics of agricultural wages (obtained from agricultural wages census reports) and of industrial wages (from other sources) to find out the trend of movements of costs—a procedure open to criticism. It is clear, however, that while a definite tendency towards a marked rise in the index numbers of wholesale prices is noticeable in the United Kingdom, U. S. A. and other countries since 1934, Indian prices exhibit no appreciable rise. The following table shows the movements of prices in India and a few other countries—

Index numbers of prices 1929=100

	1930	1931	1932	1933	1934	1935	1936	1937	1938
U. K. (B. of trade) ..	87.5	76.8	74.9	75.0	77.1	77.9	82.7	95.2	88.8
U. S. A. ..	90.7	76.6	68.0	69.2	78.6	83.9	84.8	90.6	82.5
Australia (Melbourne)	88.5	79.2	78.3	78.2	81.6	81.5	85.6	91.9	92.2
Japan ..	82.4	69.6	73.3	81.6	80.8	84.4	89.9	108.4	114.3
Canada ..	90.6	75.4	69.8	70.2	74.9	75.4	78.0	88.4	82.2
India (Cal.)	82.3	68.1	64.5	61.7	63.1	64.5	64.5	72.3	67.6

It is possible that the disparity between the price level here and abroad may be due to (1) heavier fall in agricultural prices and their halting upward movement and (2) rearmament programmes of several countries which led to a spurt in prices. Any persistent failure of Indian prices to catch up to world prices would, how-

ever, have to be attributed to 1s. 6d. ratio. Even if it could be established that this failure is not due to 1s. 6d. ratio, there would still remain a case for devaluing the rupee to initiate a rise in prices to benefit the vast agricultural population.

An important argument advanced against devaluation of the rupee is that a measure of stability in international exchange relations has already been attained and India should not cause a disturbance just at this time by devaluing the rupee. It may be pointed out, however, that the disturbance may not be so great as is feared and it would be worth while to risk some of it, in the interests of the agriculturists who form the bulk of population. Intensive enquiries in rural areas show that at the present level of prices the agriculturist cannot meet his costs (including in "costs" ordinary wages and some return for enterprise). Many of the agriculturists' costs such as rent, land revenue, maintenance charges of livestock are more or less fixed and have not fallen in proportion to the fall in prices. If agriculture had been a business and not a way of life in this country, many of those engaged in agricultural production would have closed the shop long ago. That they have not done so or can not do so is no reason why they should not be put in a position to meet their costs. Any relief given to agriculturists is bound to have a tonic effect on the entire economic system of the country.

There may be difference of opinion as to how far devaluation of the rupee would stimulate our exports.

The linking of the rupee to sterling at 1s. 6d. and the consequent depreciation of the rupee in relation to currencies based on gold did raise prices a little in India. Some advantage was secured in export trade with those countries which still remained on gold standard such as France, U. S. A., Italy and Germany but this advantage was largely neutralised on account of the imposition by these countries of high tariffs, quota systems and exchange restrictions and currency devaluation. It is highly problematic if any devaluation of the rupee at present would stimulate demand for our exports or secure a passage for them through the iron bars of numerous trade restrictions. It may, on the other hand, lead to competitive depreciation of currencies by other countries or retaliation in some other form. This danger can to some extent be mitigated by entering into trade agreements on the basis of a devalued rupee, if on other grounds devaluation is found desirable. As regards exports to countries of the sterling group, even a temporary improvement in trade could not be secured owing to the maintenance of the old rate of 1s. 6d. A lowering of exchange rate at present to stimulate exports to these countries is subject to the same risk of retaliation. On the whole it would appear that no lasting increase in our exports can be secured without a general revival of world demand for them. This in turn depends upon the relaxation of international tension and the removal of barriers to international trade. Devaluation will, however, enable India to maintain or strengthen

her competitive position in the world markets in some articles of export.

The devaluation of the rupee can be used as a lever to raise internal prices. The prices of exports and imports will rise first and the rise may slowly spread to other commodities which do not enter into India's foreign trade. This may stimulate production and trade. It is pointed out, however, that while the rise in prices of exports may take time in percolating to the primary producer, the price that he has to pay for imported goods will immediately increase. The Indian agriculturist will, therefore, obtain no advantage from devaluation of the rupee. If his costs rise as fast as prices, it is clear that no net benefit can accrue to him. A plausible reply given to this argument is that most of the farmer's costs do not depend on the prices of imported goods and in any case there is a time lag between the rise in prices and rise in costs. The agriculturist can obtain the benefit of this time lag.

A rise in the prices of imports is, no doubt, undesirable from the point of view of the consumers. It should not be over-looked, however, that consuming is not the sole function of consumers, they also work and produce. If opportunities for work and production are enlarged, the burden of slightly higher prices will be lightly borne by the consumers. A rise in the prices of imported goods will also give added protection to Indian industries,[1] particularly those which do not come

[1] In the case of large scale manufacturing industries, devaluation

under the scope of the policy of discriminating protection. The protection given by currency devaluation, is, however, indiscriminate and can be justified only if the Government policy is so halting and vacillating that indiscriminate protection is the only alternative to inadequate protection.

The present position with regard to exports and imports can hardly be called healthy and normal. The merchandise balance of trade in favour of India (including Burma) amounted to about Rs.43 crores in 1937-38 as against Rs.78 crores in 1936-37. This was primarily due to an increase in imports. Excluding Burma, the balance of trade in favour of India in 1937-38 was only Rs. 16 crores in 1937-38 against Rs. 52 crores in 1936-37. It is said that "in fact the best proof of a well chosen ratio consists of its harmony with a steady and moderate price level and a healthy and normal condition of imports and exports."[1] If this be the proof of a well chosen ratio, 1s. 6d. ratio can hardly be said to have furnished it.

The fall in prices in India has not only upset price-cost parity thus damaging production and increasing unemployment but has also brought about profound disturbances in distribution. It has strained relations

has been advocated not as a measure of additional protection but to remove the handicap of an over-valued currency under which they have been labouring since 1927. It may be noted, here, that devaluation will raise the price of imported machinery, appliances and stores and to that extent handicap Indian industries.

[1] J. C. Coyajee in *The Asiatic Review*, Vol. XXV, p. 412.

between debtors and creditors, landlords and tenants (particularly those paying contract cash rents), employers and workers and given too arbitrary an advantage to men with fixed or gradually increasing income such as the Government employees or pensioners. A rise in prices, if it can be brought about through devaluation, will not only take a load off the productive activity but also ease in great measure class relations. The interest of different classes may diverge upto a point but just as depression ultimately overwhelms all alike[1], any lifting of it will bring, sooner or later, relief to all.

An important interest to consider in any discussion of the ratio is the Government of India who have to remit annually Home charges amounting to about £32 millions. A reduction in exchange rate of two pence will increase the burden of Home charges by about Rs.6 crores and upset the budgetary equilibrium and credit of the Government of India. The Hilton Young Commission said that this was not a "decisive factor". It cannot, however, be ignored. A decrease in central revenue may not only make fresh taxation necessary but may also put a stop to the distribution of the provincial share in the proceeds of income tax. All this follows from a short range view of the matter and if this view alone were to prevail, the argument against an alteration of the ratio would be strong. It stands to reason, how-

[1] This is shown by the condition of agricultural debtors and money-lenders both of whom have suffered, the latter through inability to recover even interest, not to speak of the principal lent.

ever, that the fall in central revenue due to devaluation may be more than covered by increased receipts from income tax, railway contributions, customs etc., which a rise in prices and general trade revival will bring about.

Devaluation of the rupee can give only a temporary stimulus to prices. It is not a get-rich-quick device. But when a country is emerging from the nadir of depression it requires just that temporary stimulus to put it on the way to recovery. Devaluation is also a defensive weapon which may be used to protect internal economy. For pemanent results, however, remedies of another kind which would increase productive efficiency and lower costs of production must be applied. Devaluation is no panacea for economic ills.

Currency is a delicate instrument and when it is used to achieve non-monetary objects, it has to be used with care and precision. The time and manner of its use must be properly judged. Perhaps it could be used to the best effect in India in 1931 and later on in 1933 or 1934. The course of prices and trade must, however, be carefully watched and international monetary situation appraised and if conditions demand it, devaluation should be effected forthwith.

§ 2. An independent monetary system for India

The future of the Indian monetary system cannot be very certain when the future of the monetary systems of the world is so highly uncertain. A period of international tension and economic instability is hardly the

proper time to take definite decision about the permanent basis of Indian monetary system. This fact was recognized when in the preamble of the Reserve Bank of India Act 1934 it was laid down that "it is expedient to make temporary provision on the basis of the existing monetary system and to leave the question of the monetary standard best suited to India to be considered when the international monetary position has become sufficiently clear and stable to make it possible to frame permanent measures." The temporary provision has accordingly been made on the basis of sterling exchange standard, the Reserve Bank of India having been placed under a legal obligation to maintain rupee sterling ratio at 1s. 6d. Section 55 (2) of the Reserve Bank of India Act provides for the revision of this basis and reads as follows:

> When the Bank is of opinion that the international monetary position has become sufficiently clear and stable to make it possible to determine what will be suitable as a permanent basis for the Indian monetary system and to frame permanent measures for a monetary standard, it shall report its views to the Governor-General-in-Council.

The power to frame a permanent basis for the Indian monetary system thus lies with the Governor General-in-Council to whom the bank will report its views. One of the special responsibilities of the Governor General under the Government of India Act 1935 is to safeguard the financial stability and credit of the Federal Govern-

ment and in discharging it he will exercise his individual judgment as to the action to be taken.[1] Within the scope of this special responsibility may fall the function of determining the basis of Indian monetary system so as to maintain unimpaired the credit of India in the money markets of the world. In discharging this responsibility the Governor General may be assisted by a Financial Advisor appointed by himself after consulting (except in the case of first appointment) his ministers. Even so the power of the Federal Ministers in the monetary sphere is severely limited and very little scope is left for management of the monetary system in the interests of India.[2]

It may take a long time yet for the international monetary position to become clear and stable. With war in the offing it may get more confused and unstable. An independent monetary policy alone can safeguard Indian interests in such an emergency. The past record of currency management in this country is not such as to inspire public confidence. The excessive dependence of her monetary system on currency and credit changes in England has been a serious disadvantage for India. This dependence must be ended and a monetary system

[1] Government of India Act 1935, Sections 12, 1(*b*) and 2. These sections will become operative, however, only when part II of the Government of India Act comes into force. (Absit Omen!)

[2] No Bill or amendment which affects the coinage or currency of the Federation can be introduced into or moved in the Federal Legislature without the previous sanction of the Governor-General in his discretion. *Section* 153 *of Govt. of India Act.*

suited to Indian needs and managed to promote Indian interests evolved.

Theory and experience concur in establishing that gold standard of the pre-war or pre-depression type is unworkable in a world which has come to believe in economic nationalism. In future, conscious and deliberate management of economic life in every country is likely to be more not less. Restrictions on trade and exchange will be imposed or removed to secure national gain. The monetary policy, too, will be shaped and directed to promote the economic interests of a people. It is highly unlikely that currencies now off gold will be restored to their old (pre-devaluation) parities. Gold will certainly not be allowed to dominate currencies.

India must be keenly interested in monetary developments elsewhere but her peculiar conditions and problems require that a monetary system suited to her own needs be evolved. The idea that India must pass through the purgatory of gold standard with gold currency to reach the heaven of a managed standard not based on gold may be finally abandoned. For one reason alone gold standard may have to be rejected. It will impose on the country the need of conforming to an international standard and such conformity may narrowly circumscribe liberty of action. The internal currency of the country must be the cheapest possible to accord with the poverty of the people. It may continue to consist of rupees and currency notes and the use of cheques for internal transactions may be developed by special measures. One

rupee notes may be issued and notes of bigger denominations made convertible into notes of smaller denominations or rupees *at the option of currency authority*.[1] Adequate provision should be made for the expansion of currency to meet seasonal requirements. The Reserve Bank of India should encourage the development of a bill market so that in busy season movements of crops and internal trade may be financed by bills against which the Reserve Bank could issue currency. A certain amount of gold in the Reserves and balances with central banks will have to be kept to meet foreign obligations and inspire public confidence. Public confidence is usually a function of "currency consciousness" of the people and the progress of education may lead people to take a more rational view of the role of gold in the currency system of the country. An enquiry into the ways of reducing foreign obligations may, however, be undertaken, forthwith. The future monetary standard of India may thus be a kind of exchange standard not too exclusively dependent on gold or the currency of one country and managed solely in Indian interests. A tradition of managed currency standard has been built up in this country during the last 35 years and this tradition may well be utilized in future for the country's good.

In the past stability of exchange has been made a fetish of. India need not "monkey" with the exchange

[1] This was one of the recommendations of the Hilton Young Commission and has the merit of obviating the necessity of keeping large silver reserves.

value of the rupee but mere stability of exchange is too narrow an objective for the monetary policy of a country having large internal trade, a predominantly rural economy and struggling industries. In a period of exceptional economic disturbance, manipulation of exchange rate may have to be used as a shield to protect the internal economy from violent strains due to external forces. The Government policy in the past has been somewhat different; Sir George Schuster described it best when in a speech in the Legislative Assembly he quoted approvingly the following remarks made to him by the British Prime Minister (the late Mr. Ramsay Macdonald):

"I am always reminded of what happens when I go to sea and it is rough. I am a very bad sailor and when it is rough I get myself a deck chair in a sheltered place and I wrap myself in a rug and keep as quiet as I can."

Such an attitude may be explicable or even justifiable in a passenger on board but it hardly befits the captain of a ship on a rough sea.

APPENDIX A

Recent Phase in Ratio Controversy

The Working Committee of the Indian National Congress passed the following resolution on 14th December, 1938:—

"Since the fixation of the ratio at 1s. 6d. to the rupee all trade interests in India and public bodies have protested that this measure is against the vital economic interests of India and have insistently demanded its revision. The Government of India have hitherto resisted all these attempts and last issued a *communique* on June 6, 1938, declaring that it did not intend to make any change in the ratio for the time being and in support of that declaration sought to rely merely on the instability and uncertainty during the period of readjustment which, according to them, was likely to cause greater loss to Indian interests than any corresponding gain from the change to a lower ratio. Since June last the balance of trade has turned more and more against India. The Committee are of opinion that the rate of 1s. 6d. to the rupee has hit hard the agriculturist of this country by lowering the price of agricultural commodities and given an undue and unfair advantage to imports into this country. The Working Committee is satisfied that the rate of 1s. 6d. cannot any longer be maintained by large exports of gold which have been very injurious to the country. Matters have now reached a stage when the rate can only be maintained by a policy of contraction of currency and credit and by further depletion of the gold and sterling resources of India and particularly the Paper Currency Reserve. Those sterling resources

have already been used up to an alarming extent and there is a danger of further serious depletion taking place if efforts continue to be made by the Government of India to maintain the present ratio. The Working Committee look upon such prospect with the utmost concern and anxiety. In view of this situation the Working Committee have come to the conclusion that the best interests of the country demand that efforts to maintain the present exchange level should henceforth cease and urge upon the Governor- General-in-Council the necessity of taking immediate steps to lower the rate to 1s. 4d. to the rupee."

The Working Committee's criticism of the Government policy in maintaining 1s. 6d. ratio may be reduced to the following:—

1. Since June, 1938, the balance of trade has turned more and more against India, indicating the unnaturalness of the ratio under the existing economic conditions.
2. 1s. 6d. rate has hit hard the Indian agriculturist by lowering the price of agricultural commodities.
3. 1s. 6d. rate has given an undue and unfair advantage to imports into India.
4. 1s. 6d. rate can be maintained only by contraction of currency and credit and further depletion of gold and sterling resources.
5. Sterling resources have already been used up to an alarming extent to maintain the ratio.

The Government of India issued a *communique* on the 16th December, 1938, disputing the facts and coun-

tering the arguments set forth in the Working Committee's statement. It runs as follows:—

"The Government of India wish to make it clear that they have no intention of allowing a lowering of the present exchange value of the rupee. On the contrary, they intend to defend it by every means in their power and are confident of their entire ability to maintain it.

It is said that since their previous declaration of June 6, 1938, the balance of trade has turned more and more against India. The fact is that, in every month since June, the balance of trade, even excluding treasure, has been in favour of India and to an extent greater than in the corresponding month of the previous year.

It is said that the sterling resources of India, particularly those of the Paper Currency Reserve, have been used up to an alarming extent. The facts are that the assets of the Paper Currency Reserve were merged in those of the Reserve Bank in April, 1935, and that the gold and sterling resources of the bank are as high now as they were at the time of its inception and are in any event more than 50 per cent of the total liabilities as opposed to a statutory requirement of 40 per cent only. Moreover, since the inception of the Bank, 60 crores of sterling debt have been repatriated.

It is said that the 1s. 6d. ratio has hit hard the agriculturist by lowering the price of agricultural commodities. The fact is that, since June last, the trend of the price-index of the chief articles of export has been definitely upwards.

The Government of India are convinced that a lowering of the ratio in the existing international market conditions would produce no appreciable rise in what the cultivator can realize for his produce. They are equally convinced that it would produce an immediate rise in the cost of what he buys.

It would also seriously weaken the budgetary position of the Central Government and the larger Provincial Governments.

In fact, a lowering in the ratio would do no good to anybody except the moneyed and speculative interests who profit from conditions of uncertainty and disturbance or who secure an additional but unseen all round increase of 12½ per cent in the protection afforded to them at the expense of the consumer.

Altogether the Government of India have no doubt that it is their clear duty in the interests of India generally and the cultivator, in particular, to defend the present ratio to the utmost of their power. As already stated, they have every belief in their ability to do this and they are confident that drastic measures of contraction will not be necessary, except to the extent that they are forced on them by the action of speculators who place their funds abroad in the hope of bringing them back at a profit. Incidentally, they are convinced that the exchange would be materially stronger to-day, were it not for the fact that there have been large movements of funds to the United Kingdom by these same speculative interests during the last year."

The Government *communique* is cleverly worded and, while exposing to attack the weak points in the Working Committee's statement, conceals many weaknesses in the position it seeks to defend. It is, for example, true that from June to October 1938, the balance of trade was in favour of India to even a greater extent than in the corresponding period of 1937. But the period of 1937 does not furnish the correct basis for comparison; for during it imports had been stimulated by the preceding boom conditions and the balance of trade had begun to shrink. A comparison with conditions in 1936 or three or four years preceding it shows considerable fall in the total visible balance of trade.

The *communique* points out that the price-index of

chief articles of exports had an upward trend since June, 1938. The trend was, it may be said, not well-marked and in any case the rise of agricultural prices during the previous four years of recovery had been painfully slow and inadequate.

The Government meet the argument that 1s. 6d. ratio has given an undue advantage to imports into India by a counter-argument that a lowering of the ratio will only benefit those who will secure 12½ per cent increase in the protection afforded to them at the expense of the consumer (meaning the Indian industrialists) or those speculators who profit from instability in exchange.

The Government denied any depletion of the resources which are available to maintain exchange. Actually, however, the sterling balances of the Reserve Bank had fallen and the sterling assets of the Bank could not have been maintained unimpaired but for gold exports.

The Government attributed the weakness of exchange to the speculative movement of funds outside the country and expressed confidence in their ability to maintain the ratio without contraction of currency. The weakness in exchange, it is unnecessary to emphasize, is generally due to causes more fundamental than the action of some speculators and unless an adaptation to the fundamental shift in economic conditions is brought about through devaluation, contraction of currency has to be resorted to.

The arguments given in the communique against

devaluation are: *firstly*, it will produce no appreciable rise in the prices of agricultural products and will, on the other, raise the costs of the farmer; *secondly*, it will seriously weaken the budgetary position of the Central Government and the larger Provincial Governments; *thirdly*, it will benefit nobody except "moneyed and speculative interests" and Indian industrialists.

These are familiar arguments and have been dealt with in Chapter X, §1.

APPENDIX B

Automatism and elasticity in Indian Currency System

A sound currency is required, in general terms, to be simple and certain and to secure stability, automatism and elasticity. Stability means here stability in the external and internal purchasing power of the currency unit. The external and internal stabilities are, under normal conditions, closely interrelated and not incompatible but in times of exceptional economic disturbance, emphasis may have to be shifted on to internal stability. The proper criterion of the adequacy of a currency system lies in its capacity to secure balanced economic development by maintaining 'continuity of values'. The indices of this development are not merely price-cost levels but also figures about trade, employment, prices of shares and movements of capital. In working the Indian Currency system too much importance has been attached to exchange stability (*i.e.*, stability of external purchasing power) and not enough to internal stability.

Automatism

There can be no automatism in any absolute sense. Some currency systems may be more automatic than

others. Automatism in currency system cannot mean entire absence of control and management. No system has been discovered which would relieve the monetary authority of all responsibility as to its working. Even in so-called 'automatic systems' there is an element of control. The pre-War gold standard is sometimes called an automatic standard because under it gold movements freely took place and by producing their effect on prices corrected disequilibria. But the successful working of this system depended on the observance of some rules ('rules of the gold standard game') and the presence of a certain kind of economic environment. "The preservation of the system clearly depended upon the policies of Central Banks reflecting such variations as would have occurred under an automatic system of purely metallic currencies with no other types of money." An export or import of gold was allowed by the policies of Central Banks to produce its full effect through contraction or expansion of currency. If some Central Banks had adopted the policy of 'sterilizing' imported gold, the automatism of the standard could be defeated, as was actually done in post-War years. Nor would the system work automatically if the exchange parities chosen by the countries did not reflect internal prices and costs and consequently imposed a severe strain on their economic structures.

Control and management in currency matters, as in other spheres of economic life, now meet general approbation. Opinions may however differ about the objec-

tives of such control and the methods thereof.

The Indian currency system has not been automatic even in the qualified sense except between 1835 and 1893. The element of government control was definitely introduced from the time mints were closed to the free coinage of silver in 1893. Since then the system has been deliberately controlled and managed and as no monetary authority, least of all a government, can be infallible, serious mistakes were sometimes made. The currency authority has been till recently the Government of India and it was under no obligation to expand and contract currency to the full amount of the sale or purchase of sterling. As the Hilton Young Commission observed in 1926: "There is no provision as to any organic relation between the total volume of token currency and the amount of reserves. So far as the note-issue is concerned, the statutes provide for no minimum percentage of gold or sterling securities being held in the reserve as cover against the notes. Nor is there any such fixed relation in regard to the other form of token currency—the silver rupees. The amount of the Gold Standard Reserve and the time and manner of its use are wholly within the discretion of the government.........The automatic working of the standard is thus not adequately provided for in India and never has been......Under the Indian system, contraction is not, and never has been, automatic. On occasions the obligation to buy sterling exchange has been discharged by the Government without any corresponding

expansion of domestic currency." The Commission recommended gold bullion standard because, among other things it would be automatic (*i.e.*, more automatic than the pre-War exchange standard).

The management of currency and credit has been transferred to the Reserve Bank of India since 1935. In so far as the Bank is under a statutory obligation to maintain 1s. 6d. sterling rate, it has to operate the currency system with a definite objective in view.

Elasticity

Elasticity may be defined as the capacity of the currency system to meet the varying requirements of trade and exceptional demands in times of crisis. It is an important requisite for the Indian currency system because of the seasonal demand for currency to finance crop movements.

The Indian currency system was based, till recently, on the principle of fixed fiduciary issue, *i.e.*, beyond a certain amount of currency issued against securities, expansion or contraction could take place at a rate exactly corresponding to the increase or decrease of the amount of metal or coins kept in the reserves. The disadvantage of such a system is that under it currency cannot be expanded at a rapid rate owing to the statutory requirement of 100 per cent reserve against additional note-issue and in times of emergency, the system may break down.

The Paper Currency Act of 1861 provided for a

fiduciary issue (*i.e.*, issue against securities or invested portion of the reserve) to a maximum of Rs. 4 crores. The amount was increased to Rs. 14 crores by 1911. During the War years it was increased several times and stood at the end of War at Rs. 120 crores. In 1923, and 1925, provision was made to issue currency notes upto a maximum of Rs. 12 crores against hundis or internal bills of exchange. The remarks of the Hilton Young Commission about this provision explain also the difficulty of introducing elasticity in Indian currency system. "This provision has had beneficial effects in practice, but it is not in our opinion incapable of development and improvement in connection with a reorganisation of the bases of Indian currency. Any such provision depends for its proper operation on a plentiful supply of genuine trade bills. But in India, for a variety of reasons, most of the internal trade is financed by a system of cash credits or by the advance of money against demand promissory notes. It has, therefore, been found difficult to secure an adequate volume of bills as cover against the seasonal increase. As a result, the currency authority has on occasions been forced to provide for the needed elasticity by regulating its holding of sterling securities in the Reserve."

The Commission recommended the adoption of the proportional reserve system under which the reserve bears a certain proportion to the note-issue, say, 40:100. If 40 units are added to the reserve, note-issue can be increased by 100 units and if 40 units are taken out,

note-issue has to be contracted by 100 units. The range of expansion and contraction is, therefore, much wider than under the fixed fiduciary system. The system has been incorporated in the constitution of the Reserve Bank of India which has to hold 40 per cent reserve of gold bullion, gold coin or sterling securities, the amount of gold coin and bullion being not less than 40 crores of rupees in value. To secure an emergent issue of currency, there is a provision for a reduction in the reserve ratio below 40% with the sanction of the Governor-General-in-Council and on payment of a graduated tax.

These provisions are of value but to lend much needed elasticity to the currency system it is necessary to encourage the habit of using cheques as the media of payment and to develop a bill market.

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